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Supreme Court of the United States

OCTOBER TERM, 1969

VICTOR MUSCAT and R. L. HUFFINES, JR.,

Petitioners,

against,

NORTE & CO.,

Respondent.

PETITION AND APPENDIX FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review the opinion of the United States Court of Appeals for the Second Circuit entered September 16, 1969 as modified by its opinion after rehearing entered October 14, 1969.

Opinions Below

The Opinion of the Court of Appeals and its Opinion after Rehearing are reported at 416 F. 2d 1189 and are also printed in the Appendix to this petition (A1-A5; A6-A8, respectively).* The opinion of the District Court for the Southern District of New York is printed in full in this Appendix (A9-A40). The opinion of the District Court

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* References to the Appendix will be preceded by the letter "A". All references without such designation will be to the Appendix and to the Exhibits which comprised the record in the Court of Appeals.

denying petitioners' motion for a new trial or a rehearing on newly discovered evidence is reported at 288 F. Supp. 855 and is also printed in full in the Appendix to this petition (A41-A66).

Jurisdiction

The opinion of the Court of Appeals which affirmed the judgment of the District Court in all respects was entered on September 16, 1969. The judgment was in favor of Defiance Industries, Inc. ("Defiance") in a derivative stockholder's suit arising out of the acquisition of 100% of the Stock of Insurance and Industrial Enterprises, Inc. (I.I.E.) for shares issued by Defiance. Petitioners moved for a rehearing only on the issue of prejudgment interest on September 26, 1969. On October 14, 1969 the Court of Appeals upon granting the rehearing remanded the case to the District Court for reconsideration only of the award of prejudgment interest and adhered to its prior affirmance of all the other aspects of the Judgment of the District Court. The issue of prejudgment interest was settled at a reduced rate by stipulation (A69-A71) without prejudice to this petition. The judgment (A67-A68) which this Court is requested to review was entered in the District Court on July 2, 1969 and affirmed in pertinent part by an opinion of the Court of Appeals entered September 16, 1969. By an order dated December 13, 1969 (A74), Mr. Justice Harlan extended the time to file this Petition to January 30, 1970.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Questions Presented

1. Whether, under the Federal law of equitable remedies, the corporate entity itself (Defiance) which acquired one hundred per cent of another corporation (IIE) in

circumstances tantamount to a merger was damaged by its issuance of an allegedly excessive number of shares of its own stock to the stockholders of the acquired corporation (IIE); or whether the only damage was *to the stockholders* of the acquiring corporation (Defiance) by reason of the disproportionate percentage of stock received by the stockholders of the acquired corporation (IIE)?

2. Whether under Rule 16 of the Federal Rules of Civil Procedure a District Court may ignore a stipulation in a pre-trial order as to the "market value" of shares issued, and, after its original opinion, make its own independent inquiry into the matter already determined in the pre-trial order? Is this orderly and permissible procedure under the Federal Rules of Civil Procedure?

3. Whether *scienter* must be proved in order to hold petitioners liable in money damages for causing the corporation to issue shares as a result of a shareholders' vote based on an allegedly false and misleading proxy statement in violation of Sections 10(b) and 14(a) of the Securities Exchange Act of 1934 and Rules 10b-5 and 14a-9 promulgated thereunder?

4. Whether a layman can rely on a careful review by the SEC, which took almost one year, during which time all the material figures were disclosed, the accounting procedure in reporting certain items as surplus or earnings was commented upon and necessarily reviewed, and the information in the proxy positioned according to the SEC's instructions? Does such reliance fairly negate the findings that said proxy statement was false and misleading to the average stockholder?

5. Whether the decisions below erred in determining that the terms of the exchange were grossly unfair to Defiance or its shareholders?

Statutes Involved

The pertinent provisions of the Statutes (15 U.S.C. §§ 78j and 78n) and Regulations (17 C.F.R. §§ 240.10b-5; 240.14a-9; and F. R. Civ. P., Rule 16), are all printed in the Appendix hereto (A69-A72).

Statement

Petitioners were found jointly and severally liable for the amount of $4,355,595 in the United States District Court for the Southern District of New York, upon a trial without jury, for breaching their common law fiduciary duties as officers and directors to Defiance. Of this amount $2,992,940 represents the purported loss to Defiance under the first and third Causes of Action (A34). A District Court award of prejudgment interest in the amount of $1,156,298 was remanded upon rehearing by the Court of Appeals for further consideration and was subsequently settled at a reduced rate without prejudice to this petition. Liability under the first Cause of Action, on which jurisdiction is based on diversity of citizenship, was imposed because the acquisition of the shares of IIE, of which petitioners and one Edward Krock owned approximately 77%, by Defiance in exchange for shares of Defiance Class B Common Stock was at a ratio of exchange found to be grossly unfair to Defiance. Under the third Cause of Action on which jurisdiction was based on § 27 of the Securities Exchange Act of 1934 (15 U.S.C. § 78aa), the District Court also found that petitioners had violated Section 14 of the Exchange Act (15 U.S.C. § 78n) and Rule 14a-9 (17 C.F.R. § 240.14a-9) promulgated thereunder by procuring from Defiance shareholders approval of the exchange of 4⅞ shares of Defiance Class B Common Stock for each share of IIE Common Stock by means of a false

and misleading proxy statement.* The exchange of shares was consummated on July 13, 1962 and Defiance acquired 99,998 IIE shares, which was 100% of IIE's issued and outstanding shares (135a-136a). In practical effect, this was a merger of IIE into Defiance.

The District Court held, and the Court of Appeals affirmed, that Defiance, rather than its non-controlling shareholders, was damaged by the fact that Defiance issued too many of its own shares (not money or any property) in exchange for 100% of the IIE stock.** A corporation purportedly worth about 3 million dollars allegedly "lost" three million dollars, as the Courts found, and yet was worth seven million dollars after the exchange. Both the District Court and the Court of Appeals found that the corporation was damaged although in reality only the non-controlling shareholders of Defiance were damaged in the amount of only $625,038 by the rearrangement of their equity positions in the corporation.***

At the same time, the recovery allowed by the District Court and the Court of Appeals allowed a double windfall

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* Under the second Cause of Action, petitioners were found to have appropriated a corporate opportunity by purchasing certain IIE shares from one Griffith at a price of $20.94 per share and subsequently exchanging those shares for 4⅞ shares of Defiance Class B Common Stock with a value found to be worth $70.51. This cause of action is not a part of the instant petition.

** The ratio of exchange was fixed by the Directors of Defiance based on a recommendation by Hayden Stone, Inc., an investment firm that had been retained for the purpose.

*** Petitioners and Krock (as well as IIE and Nablico) held approximately 34% of Defiance Class B Common shares so the non-controlling shareholders held 66% or 147,132 shares of the 220,700 shares outstanding. Using the District Court's own extreme figures, at $14.49 per share, the independent stockholders had shares valued at $2,131,743. The total value of the combined companies became

(*footnote continued on following page*)

to the minority stockholders of IIE who had already received an excess number of Defiance shares. The other 23% of independent IIE stockholders were found already to have received about $1,600,000 for their shares when they should have received only about $930,000. Thus, based on the figures found by the Courts below, the judgment gives them, in addition to the almost $700,000 excess they have already received, a large additional windfall as Defiance shareholders sharing in the corporate recovery.

The District Court in awarding damages to Defiance instead of its non-controlling shareholders rejected the *market value* of Defiance shares on the American Exchange and valued its stock at $14.49 per share or a total value of $7,063,904 based solely on a report prepared by Hayden Stone, Inc. In the process, the District Court ignored (1) the pre-trial order which stipulated that the Defiance shares exchanged had "a *market value* of $5,667,211 (based on a *value* of $11.625 per share) . . ." (139a); (2) the portion of the amended complaint which was amended again *after trial* stating that the fair and reasonable value of each Defiance share at the time of the exchange to have been $11.50 (13a); and (3) the actual market price at the time of the exchange which was $7.75 (137a).* Petitioners at

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(*footnote continued from previous page*)

$7,254,238 ($4,056,295 value of IIE at $40.51 per share plus the aggregate Defiance value of $3,197,943). The independent stockholders then held 20.77% of Defiance after the exchange (147,132 out of 708,202 shares) or $1,506,705 worth of B stock. The difference between their original equity of $2,131,743 and their subsequent equity of $1,506,705 is $625,038—which is the full loss to *all* the independent stockholders. Yet, the loss to the corporation was found to be $2,992,940 (A34). The figure of $625,038 as the loss to the independent shareholders of Defiance was not contested below by the Respondent.

* If the $11.625 figure is used, the independent Defiance shareholders would have been damaged only in the amount of $335,034 based on the formula used in the preceding footnote.

trial, possibly because they were lulled by the stipulation in the pre-trial order, the admission in the amended complaint, and the actual market price made no effort to contest the value of Defiance shares in the exchange and specifically asked the District Court in a letter accompanying their post-trial memorandum for leave to be heard on the issue of damages in the event that liability should be found (518a). This letter was ignored by the District Court and it was not until the petitioners' motion for a new trial or rehearing that the District Court commented on the market price of Defiance shares, adhering to its original decision and again ignoring the pre-trial order, the amended complaint and the actual market price. In fact, the District Court, in order to support its original rejection of "market value" as provided in the stipulation specifically requested further evidence with respect to the nature of the market for Defiance shares on the American Exchange. The Court of Appeals simply stated that "[a] study of the record shows ample support to Judge Mansfield's findings in his conclusion that in the acceptance of the comparative valuations of Defiance and IIE stock . . . . the defendants acted in violation of their fiduciary duties as controlling officers and stockholders of Defiance" (A3).

Turning to the third Cause of Action which was added to the Complaint after trial had begun and which alleged violations of the Proxy Rules in procuring approval of the exchange from Defiance shareholders, the District Court found that the Proxy Statement was false and misleading because the earnings of National Bankers Life Insurance Co. ("Nablico"), a subsidiary of IIE were "overstated". Although the District Court found that "Huffines and Muscat, two knowledgeable and experienced business executives in charge of Nablico's affairs, were aware of its true earnings" (A34), the Court of Appeals apparently agreed with petitioners that there was no proof that they gave any

instructions whatever to Nablico's controller as to the figures to use for Hayden Stone or the proxy statement, when in its opinion after rehearing it remanded for further consideration the award of prejudgment interest ordering that "the district court should make specific findings on the personal wrongdoings of Huffines and Muscat" (A7). Despite the fact that the issue of petitioners' guilty knowledge (*scienter*) remained unclear from the record, the Court of Appeals affirmed the judgment awarding damages for violations of Sections 10 and 14 of the Securities Exchange Act of 1934 and Rules 10b-5 and 14a-9 promulgated thereunder.

With respect to the proxy statement, the District Court found, and the Court of Appeals stated that it was justified in so finding (A3), that the proxy statement (Ex. 1, pp. 74-75) was false and misleading largely in that Nablico's earnings for the years 1958 to 1960 were substantially inflated because retroactive increases in life insurance reserves required by the Texas Insurance Commission were charged directly to surplus rather than to the income account, although this practice was in accordance with normal insurance company reporting to State agencies (A21).

The District Court (as affirmed by the Court of Appeals without further comment) also found certain omissions and distortions in the proxy statement which cannot be dealt with at proper length here. Summarily stated they were: (a) a transaction in which an individual's minority interest of ten per cent in IIE had been bought by the defendants was disclosed under the heading "Principal Owners of Stock" instead of under "Market Price". It was held (i) to be "not . . . in a meaningful location" (A25-A27); and that (ii) the statement that there was "no market" was misleading (*ibid.*); (b) the failure to state plainly that Nablico's declining volume of life insurance

gave a "distorted picture" of earnings (A27-A28); and (c) although the proxy statement revealed that Nablico was a party to six lawsuits involving claims by policyholders and that counsel thought the claims unjustified, it failed to state that a $5,500 judgment had been obtained by two policyholders in a trial court (A28).

The SEC treatment was as follows: As to the treatment of increase of life policy reserves after year-end, the SEC staff saw this presentation, for it even suggested moving a particular large item from the unassigned surplus to the income account, but raised no objection to the treatment of the other items just as clearly shown in the unassigned surplus account (Ex. AO, p. 4; Ex. BV, p. 41; Ex. 1, pp. 74-75).

As to the purchase of the ten per cent interest, it was the SEC in its letter of comment that instructed the lawyers preparing the proxy statement precisely where to place the item (354a-355a; 367a; Ex. A, p. 6).

The exact language which the Court found gave a "distorted picture" of earnings was language reviewed by the SEC. The lawyers accepted the SEC's comments and the defendants accepted them as well.

The Court of Appeals opinion did not address itself to the effect of the careful SEC review and comment, although it was specifically argued.

REASONS FOR GRANTING THE WRIT

Summary

I

After the decision in *Mills* v. *Electric Auto-Lite Co.*, No. 64, decided January 20, 1970, the case at bar presents the next important question—the appropriate Federal equitable remedy to be awarded in a shareholders' derivative action where there is both jurisdiction based on violation of Section 14(a) of the Securities Exchange Act and diversity of citizenship jurisdiction.* Although there is a conflict among the Courts of Appeals, under the mandate of *Guaranty Trust Company* v. *York*, 326 U. S. 99, 105 (1945), this Court on common law diversity claims, as well as on Section 14 claims (see *Mills* v. *Electric Auto-Lite Co., supra*), is free to fashion a federal equitable remedy irrespective of state law.

The Court of Appeals specifically stated that the District Court "was clearly correct in finding that Defiance suffered damages as a result of the issuance of almost 500,000 additional shares for grossly over-valued consideration. See *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (5th Cir. 1960), cert. denied, 365 U. S. 814 (1960)." (A8)

We urge that the only persons harmed by the exchange of shares were those non-controlling shareholders of Definance who lost their proportionate share of the equity of the corporation since the corporation itself, in what was in practical effect a merger, gave up nothing but pieces

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* We urge that after a full trial, where there is an award of monetary damages in a proxy-merger situation, such award in almost all situations will be upon both the common law and Federal claims as it was in the instant case and as it would have been in the *Mills* case had there not been a motion for partial summary judgment and had the merger been found to be unfair.

of paper representing proportionate equity in the corporation. We submit that since the excessive recovery went to a party not in fact damaged, the decision below in its application of the *Hooper* case was erroneous.

Moreover, as corporate acquisitions increase and derivative actions multiply, the problem of what relief is truly equitable will have to be faced by the Federal Courts in the next decade. As noted in *Mills, supra,* the simple derivative recovery may not be the only answer. A derivative suit is merely an equitable form of action. The measure of recovery does not, in justice, have to be the same in the case of every recovery merely because the action is, in form, a derivative suit in the name of the corporation.*

In line with this reasoning, we further submit that the mandate of this Court that equity be done by minority stockholders (*Southern Pacific R.* v. *Bogert,* 250 U. S. 478, 497 [1919]) should result in an award limited to the only persons damaged, the non-controlling shareholders of Defiance at the time of the exchange of stock for stock. This theory was rejected by the Court of Appeals on the ground that it is "wholly impractical and unmanageable", distinguishing its own decision in *Perlman* v. *Feldmann,* 219 F. 2d 173 (2d Cir. 1955), on the erroneous ground that the corporation was in fact here damaged by the exchange (A4). This rejection of an equitable solution, in the age of the computer, is contrary to the principles of equity. With modern transfer records, the difficulty of finding who were shareholders on a given day is minimal compared with the avoidance of unwarranted damages and unjustifiable windfalls.

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* The Court has granted certiorari in *Ross* v. *Bernhard,* No. 42, argued 11/10/69, which will determine another aspect of the derivative suit as one in equity—whether stockholders bringing a derivative suit under the Investment Company Act are entitled by the Seventh Amendment to a jury rial.

II

Both the District Court and the Court of Appeals completely ignored a stipulation incorporated into the pre-trial order that the shares of Defiance had a "market value" of $11.65 per share on the date the proxy statement was issued. Since no attempt was made to withdraw the stipulation either before or during the trial, it was binding on the trial Court; and to ignore formal stipulations of such importance to the issue of damages ($5,667,211 value per pre-trial order; $7,063,904 value per trial Court finding) is to undermine the integrity of pre-trial procedures.

We urge that this Court, as supervisor of the procedure in the Federal courts, should determine whether it was a violation of Rule 16 of the Federal Rules of Civil Procedure for the trial Court to ignore this stipulation of fact in the pre-trial order, and, instead, to specifically call for evidence to support his reasons for ignoring it—to the prejudice of parties who apparently relied on the pre-trial order to the degree that half the case was not tried.

III

Although the District Court found that petitioners were aware that the proxy statement was false and misleading, the Court of Appeals apparently was not satisfied that there was clear proof of "personal wrongdoing" but affirmed the judgment, merely remanding for a further consideration of pre-judgment interest upon rehearing.* Petitioners obviously relied upon the advice of their accountant, lawyer

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* Although in its original opinion regarding pre-judgment interest the Court of Appeals spoke of the "calculated fraud of the defendants" (A5), in its opinion on rehearing it remanded to the District Court (also on the question of pre-judgment interest) to "make specific findings on the personal wrongdoings of Huffines and Muscat" (A7). Since no distinction was ever made as to the relative culpability of Huffines and Muscat, the statement relates to both.

and independent appraiser as well as on the SEC. Despite this the Court of Appeals affirmed the finding that petitioners had violated Section 14 of the Exchange Act and Rule 14a-9 and the award of damages therefor.

We urge that *scienter* is required to hold a person liable in money damages for violations of Section 14 and Rule 14a-9 where, as here, these violations overlap with violations of Rule 10b-5.*

IV

The SEC staff reviewed the material for the proxy statement in an unusually lengthy and detailed manner. Most of the substantial matters found by the Courts below to be misleading were, in fact, seen in their final form by the SEC who made no objection to the form or content. The lawyers accepted the SEC's comments, adhered to their suggestions and presented the resulting proxy statement to the defendants for approval. The defendants have now been told by the Courts that their duty to discover the omissions, misstatements and misplacements was of a higher standard than the SEC, in a careful review, required of itself.

While not urging that SEC review of a proxy statement gives absolution (see Rule 14a-9(b)), we do contend that where the matter has been disclosed to the SEC (and not concealed) the conclusion that the public shareholder was misled by the same disclosed material puts too heavy a

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* In light of the fact that the Court has held in *Mills* v. *Electric Auto-Lite Co., supra,* that proof of causation and reliance is unnecessary to a cause of action for damages under Section 14 of the Exchange Act and Rule 14a-9, we respectfully request that the Court consider the requirement of *scienter* in an action for damages at this time. Moreover, the problem raised by the relationship between §§ 10 and 14 has recently been noted in *SEC* v. *National Securities Inc.,* 393 U. S. 453, 468 (1969), without a unanimous concurrence.

burden on directors. A realistic approach would hold that in such a situation, negligence or even fraud by the directors is negated by the SEC review. (See Judge Friendly in *General Time Corp.* v. *Talley Industries, Inc.,* 403 F. 2d 159, 163 [2d Cir. 1968]). That still leaves culpable those who withhold information from or affirmatively deceive the SEC, or where unfortunately through pressure of time, the SEC has not made a thorough review. Cf. *J. I. Case* v. *Borak,* 377 U. S. 426 (1964).

Indeed, the importance of the weight to be given SEC clearance under circumstances presented by the instant case with respect to the inter-related question of the necessity to prove *scienter* in an action for damages under Sections 10 and 14 of the Exchange Act are of paramount significance to the management of today's corporations, for if good faith and the expertise of professionals cannot prevent liability for damages in huge amounts, then the pendulum in favor of investor protection has swung too far and will overly discourage healthy economic growth.

AS TO QUESTION 1

The federal law of equitable remedies should require that the independent shareholders, the persons actually damaged, rather than the corporation, which was not damaged, recover money damages when the corporation issues its own shares for inadequate consideration in a practical merger.

The Court of Appeals refused to award damages to the independent shareholders of Defiance and said that the District Court "was clearly correct in finding that Defiance suffered damages as a result of the issuance of almost 500,000 additional shares for grossly overvalued consideration. See *Hooper* v. *Mountain States Securities Corp.,* 282 F. 2d 195 (5th Cir. 1960), cert. denied, 365 U. S. 814 (1960)." This was the Court's conclusion although the

record did not indicate whether Defiance was actually "'deprived' of the principal sum" or "whether Defiance passed up other, reasonably available and attractive opportunities to use these shares to raise cash or to purchase fully-valued assets" (A8).

This conclusion is directly contrary to the thrust of this Court's language in *Mills* v. *Electric Auto-Lite Co., supra:*

> "Monetary relief will, of course, also be a possibility. Where the defect in the proxy solicitation relates to the specific terms of the merger, the district court might appropriately order an accounting to ensure that *the shareholders* receive the value that was represented as coming to them." (Emphasis ours).

We urge that in light of the decision in *Mills,* the award of damages to Defiance instead of its independent shareholders was erroneous and that this Court, as a matter of Federal equity jurisprudence, is free to and should remedy the gross injustice of the huge award below, as well as formulate basic rules on the nature of recovery in derivative shareholders' suits, which are now legion.

In the case at bar, Defiance acquired 100% of the stock of IIE (135a-136a). In practical effect this was the same as a merger. It was as if IIE had been merged into Defiance and Defiance had then recreated a subsidiary. For all practical purposes the surviving entity was Defiance which now owned 100% of IIE. If more shares were issued by Defiance than was proper, the additional shares given to the shareholders of IIE simply gave them a disproportionate equity in Defiance. Defiance itself lost nothing. The arrangement between these two groups of stockholders, the former Defiance holders and the former IIE holders, resulted in damage to the former group of stockholders but not to the corporate entity itself. The disparity in the result reached below is indicated by the fact that there was no challenge to the conclusion that upon the District

Court's own findings of relative values, the maximum loss to the independent shareholders of Defiance (other than the defendants' group itself) was no more than $625,038 (fn. pp. 5-6, *supra*), whereas the loss to the corporate entity was found to be $2,992,940.

In *Hooper* v. *Mountain States Securities Corp., supra,* a suit by a Trustee in Bankruptcy on behalf of a bankrupt estate, there was no merger or its equivalent involved. In that case shares were simply issued for worthless property.* Similarly, in *Ruckle* v. *Roto-American, Inc.,* 339 F. 2d 24 (2d Cir. 1964), there was no merger or its equivalent involved. Shares were to be issued by the corporation for cash in circumstances where, under the allegations, the corporation should have been able to get into its own treasury more dollars per share. We believe that it is inequitable to take the rigid view that in every case where shares are issued by the corporation there is damage to the corporation if the shares issued are excessive in number.

Here shares were issued in exchange for shares. No money or other property passed.

As this Court stated in the *Mills* case:

> "In selecting a remedy the lower courts should exercise 'the sound discretion which guides the determinations of courts of equity,' keeping in mind the role of equity as 'the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims' *Hecht Co.* v. *Bowles,* 321 U. S. 321, 329-330 (1944)."

This Court has also stated, by Mr. Justice Brandeis:

> "The purpose of this proceeding is not to punish the

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* We note that the Petition for Certiorari in *Hooper* v. *Mountain States Securities Corp., supra,* did not raise the issue of whether a corporation issuing its shares for inadequate consideration is in fact damaged.

> . . . [defendant] but to declare and enforce its obligation as trustee. The minority stockholders who seek equity should do equity; and a court of chancery has power in granting relief to prevent unjust enrichment of the minority stockholders at the expense of the . . . [defendant]." *Southern Pacific Co.* v. *Bogert,* 250 U. S. 478, 497 (1919).

Moreover, in the instant case, since no property was in fact taken from the corporation which would affect the rights of creditors (who in fact had a greater pool of assets from which to satisfy debts), the "normal" enforcement by the corporation of fiduciary obligations should *not* be applied by a court of equity. See *Pepper* v. *Litton,* 308 U. S. 295, 307 (1939).

In *Perlman* v. *Feldman,* 219 F. 2d 173 (2d Cir. 1955), the Second Circuit itself did not direct redress to the corporate entity, but allowed the minority stockholders to prevail as a class. There a corporate asset—the corporate opportunity—was sold by the majority.

In *Perlman* the plaintiffs, it is true, sought the result. Here the plaintiff stockholder, in a derivative suit does not. But should the desires of the derivative suit shareholder—often with relatively few shares—determine the Chancellor's remedy?

We submit that the derivative suit is merely a form of action. Equity can mold its decree to do justice. Mere lip service to the dogma that in a derivative suit the corporation itself *must* be the beneficiary does not square with the need of equity to do equity. Where realistically, the damage is not to the corporate entity but to a group of shareholders, the loss to those shareholders should be the measure of compensation. Otherwise, as here, the damages awarded for "loss" to the corporate entity far exceed the actual loss suffered by the minority stockholders. This is unrealistic and unfair.

The shareholders of the acquired corporation—who were not in the defendants' group—received a windfall when they originally got more shares of Defiance than they should have. Under the decision below they are now given a second windfall since they now, as shareholders of Defiance, share in the recovery by the corporation (Defiance)—even though they had previously received too much. Indeed, in an analogous situation the Court, sitting as a court of equity, in *Bank of Marin* v. *England,* 385 U. S. 99, 103 (1966), decided that "to permit . . . recovery only against the party that benefited from the transaction is to do equity." In the instant case, the threat is *not* of double recovery, as in *Bank of Marin,* but of more than quadruple recovery.

So far as the defendants are concerned, it may be true that to the extent that they have retained their stock ownership in Defiance they will benefit to some extent in the corporate recovery. But this assumes that in the interim of seven years since 1962—the time of the alleged wrong—they have not sold their stock, and that if they have not sold their stock, they have the cash required to pay the enormous judgment and thus reap their share of the indirect benefit of the corporate recovery. These considerations are presented to the Court as points of obvious general application, as are the considerations of double-windfall to the non-defendant shareholders.

Additionally, in the instant case proof of *scienter* is unclear (see pp. 26-29, *infra*). We submit that this is a further equitable consideration in determining to whom and the extent to which damages should be awarded in a derivative suit.

The derivative shareholders' suit is only a form of action. Equity should not be in a straitjacket because of the form of action. Where justice requires it, equity judges should be instructed to shape their decrees so as to repair loss for those who really suffered it—in this case

the independent shareholders of Defiance—rather than to award damages to the corporate entity itself because of a rigidity of approach. See *deHaas* v. *Empire Petroleum Co.*, 300 F. Supp. 834 (D. Colo. 1969).* Since we believe Federal equitable remedies do not depend upon State law even in diversity cases (*Guaranty Trust Co.* v. *York*, 326 U. S. 99 [1945]), we respectfully suggest that it is both timely and necessary for this Court to address itself to the question.

As stated by Judge Roscoe Pound in the classic case of *Home Fire Ins. Co.* v. *Barber*, 67 Neb. 644, 93 N. W. 1024 (1903):

> "If a wrongdoer deserves to be punished, it does not follow that others are to be enriched at his expense by a court of equity." (93 N. W. at 1035)

In discussing the nature of a derivative suit, Judge Pound also noted that there is a "fallacy in the view that one who has not been injured by a transaction and is not affected thereby can acquire a right to sue in equity to set it aside . . ." (93 N. W. at 1030).

Judge Pound continued:

> "Nowhere is it more necessary for a court of equity to adhere steadfastly to this maxim ['it is the province and delight of equity to brush away mere forms of law'], and avoid the danger of allowing their remedies to be abused, by penetrating all legal fictions and disguises, than in the complex relations growing out of corporate affairs."

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* In *de Haas*, the recovery for damages caused by a 1962 merger went to the *public* shareholders of American which was merged into Empire Petroleum in 1966 and liquidated. We respectfully urge that the Court in the instant case erred when it apparently thought it too difficult to award damages to the public shareholders of Defiance (which has since been merged into El Tronics, Inc.).

> "[*W*]*here no question of title is involved,* but some equitable remedy is sought in the corporate name, depending purely on the doctrines of a court of equity, the court, to prevent abuse and perversion of its doctrines and remedies, will look through the corporation to the real parties in interest . . . [To hold otherwise would turn] principles meant to do justice into rules to be administered strictly without regard to the result. It is contrary to the very genius of equity." (93 N. W. at 1032-3; emphasis ours)

To justify the unwarranted result in the instant case, the Court of Appeals could say merely that petitioner's theory "is wholly impractical and unmanageable in that it would shift the burden of proving a right of recovery to a large class of persons many of whom may never be determined and found" (A3). We urge that the burden of proof is not affected and that a recovery to public shareholders is neither impractical nor unmanageable. This Court, as a matter of the federal law of equitable remedies, should recognize that we have come into the age of computerized transfer sheets and stock certificates. The Court below failed in its duty to act as "the instrument for nice adjustment and reconciliation . . . between competing private claims." *Mills* v. *Electric Auto-Lite, supra.*

This is *not* merely a case where State law was erroneously applied, but one involving the establishment of the proper remedy of the *Federal* courts of equity in derivative suits which also involve Federal proxy violations. Federal courts are still free to fashion their own equitable remedies regardless of existing State law even after *Erie R. Co.* v. *Tompkins,* 304 U. S. 64 (1938), and even after 1940 when the Federal Rules of Civil Procedure united law and equity. This was established in *Guaranty Trust Co.* v. *York,* 326 U. S. at 105, where Mr. Justice Frankfurter, said:

> ". . . In giving federal courts 'cognizance' of equity suits in cases of diversity jurisdiction, Congress never gave, nor did the federal courts ever claim, the power

to deny substantive rights created by State law or to create substantive rights denied by State law.

This does not mean that whatever equitable remedy is available in a State court must be available in a diversity suit in a federal court, or *conversely, that a federal court may not afford an equitable remedy not available in a State court. State law cannot define the remedies which a federal court must give simply because a federal court in diversity jurisdiction is available as an alternative tribunal to the State's courts.* Contrariwise, a federal court may afford an equitable remedy for a substantive right recognized by a State even though a State court cannot give it.*" (Emphasis ours.)

We note that despite this very strong language by the Court and its citation of pre-*Erie* and post-*Erie* cases which support the doctrine, the Federal "equitable remedial rights doctrine" has been criticized (2 MOORE'S FEDERAL PRACTICE § 2.09)** and that there is a conflict in the Circuits as to its application. Thus, the Third Circuit has upheld the doctrine that Federal courts in diversity cases will apply its own equitable remedies regardless of contrary state law (see *Black & Yates Co.* v. *Mahogany Ass'n.*, 129 F. 2d 227, 233 [3rd Cir. 1942], cert. denied 317 U. S. 672 [1942]).*** On the other hand, the Second Circuit

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* Citing *Pusey & Jones Co.* v. *Hanssen*, 261 U. S. 491 (1923). Another post-*Erie* case which also cites *Pusey & Jones* with approval is *Kelleum* v. *Maryland Casualty Co.*, 312 U. S. 377 (1941). See also *Sprague* v. *Ticonic National Bank*, 307 U. S. 161 (1939), cited with approval in *Mills* v. *Electric Autolite Co., supra.*

** See also Notes, 55 YALE L. J. 401 (1946); 67 HARVARD L. REV. 836 (1954).

*** The other Third Circuit cases are *Maxwell* v. *Enterprise Wall Paper Mfg. Co.*, 131 F. 2d 400 (3d Cir. 1942); *First Camden National Bank & Trust Co.* v. *Aetna Casualty and Surety Co.*, 132 F. 2d 114 (3d Cir. 1942), cert. denied 319 U. S. 749 (1943); *Orth* v. *Transit Inv. Corp.*, 132 F. 2d 938 (3d Cir. 1942); *Campbell Soup Co.* v. *Wentz*, 172 F. 2d 80 (3d Cir. 1948); *Anheuser-Busch, Inc.* v. *DuBois Brewing Co.*, 175 F. 2d 370, 373 (3d Cir. 1949), cert. denied

(*footnote continued to following page*)

rejected this doctrine in *Frank* v. *Wiltschek*, 209 F. 2d 493 (2d Cir. 1953, Judge Frank dissenting). See also *Columbian Nastri & Carta Carbone* v. *Columbia R. & C. Mfg. Co.*, 367 F. 2d 308, 313 (2d Cir. 1966).*

We urge that the Federal "equitable remedial rights doctrine" is viable with respect to shareholders' suits and that this Court should declare as a matter of Federal law that a huge recovery directly to the corporation where the corporation has not been damaged, as in the case at bar, cannot be tolerated in a derivative suit (to remedy violations of both state and federal law) where the Federal Court is sitting as a court equity.

In circumstances which are less compelling than those of the case at bar because those corporations were deprived of property belonging to the corporation and not merely its own shares, other courts of equity have permitted the

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(*footnote continued from previous page*)

339 U. S. 934 (1950); *Hertz* v. *Record Publishing Co.*, 219 F. 2d 397, 398 n. 2 (3d Cir. 1955), cert. denied 349 U. S. 912 (1955); *Mintzer* v. *Wright & Co.*, 263 F. 2d 823 (3d Cir. 1959).

* The other Circuits are equally divided. The Fourth and Seventh Circuits recognize the "equitable remedial rights doctrine" (*General Electric Co.* v. *American Wholesale Co.*, 235 F. 2d 606 [7th Cir. 1956]; *Purcell* v. *Summers*, 145 F. 2d 979 [4th Cir. 1944]; see also dissenting opinion by Judge Craven in *Atkins* v. *Schmutz Mfg. Co.*, 401 F. 2d 731 [4th Cir. 1968]), while the Fifth, Ninth and Tenth Circuits apparently do not (*Aerosonic Corp.* v. *Trodyne Corp.*, 402 F. 2d 233 [5th Cir. 1968]; see also *Kohler* v. *McClellan*, 156 F. 2d 908 [5th Cir. 1946], cert. denied *sub nom. Kohler* v. *Humphrey*, 329 U. S. 781 [1946]; see also *Pioche Mines Consolidated, Inc.* v. *Dolman*, 333 F. 2d 257, 273 [9th Cir. 1964], cert. denied 380 U. S. 956 [1965]; *Meyer* v. *City of Eufaula*, 132 F. 2d 648 [10th Cir. 1942]). There are conflicting decisions in the Eighth Circuit (Compare *Ferguson* v. *Marble Savings Bank of Rutland, Vt.*, 105 F. 2d 592 [8th Cir. 1939], with *Whitaker & Co.* v. *Sewer Improvement District No. 1*, 221 F. 2d 649 [8th Cir. 1955]), and the First Circuit has noted the problem without deciding it (*Atlantic Wool Company* v. *Norfolk Mills, Inc.*, 357 F. 2d 866, 870 n. 9 [1st Cir. 1966]).

We note this conflict although to our knowledge neither the law of Ohio nor the law of New York would prohibit recovery directly to independent shareholders although the suit is brought derivatively on behalf of the corporation.

recovery to go directly to minority shareholders although the form of the action was derivative. See *deHaas* v. *Empire Petroleum Co., supra; May* v. *Midwest Refining Co.*, 121 F. 2d 431 (1st Cir., 1941), cert. denied 314 U. S. 668; *Eaton* v. *Robinson*, 19 R. I. 146, 32 Atl. 339 (1895); *Brown* v. *DeYoung*, 167 Ill. 549, 47 N. E. 863 (1897); *Matthews* v. *Headley Chocolate Co.*, 130 Md. 523, 100 Atl. 645 (1917); *Gallagher* v. *Perot*, 112 Misc. 717, 183 N.Y.S. 257, 260 (Sup. Ct. 1919), affd. 200 App. Div. 867, 191 N.Y.S. 926 (2d Dept.), affd. 234 N. Y. 516, 138 N. E. 428 (1922).

Under the circumstances of the case at bar, we urge that this Court can and should, as a matter of Federal law provide for a Federal equitable remedy in derivative suits which would permit, in proper cases, recovery directly to the independent shareholders. Indeed, not only is this the appropriate remedy under the diversity cause of action, but also under cause of action alleging violations of the Securities Exchange Act since both Sections 10(b) and 14(a) are "for the protection of investors" (the independent shareholders of Defiance in the case at bar).

AS TO QUESTION 2

Rule 16 of the Federal Rules of Civil Procedure was violated when the District and Circuit Courts ignored the crucial stipulation in the pre-trial order which established the "market value" of each Defiance share.

The parties made a stipulation, approved by the District Court as a pre-trial order. "The parties agreed that the trial of this action should be based upon this order and upon the pleadings as amended" (132a). "The parties stipulated that the following facts are not in dispute in this action" (132a): "... Defiance issued 487,502 shares of its Class B stock having a market value of $5,677,211 (based on a value of $11.625 per share, the average between the bid and asked price on the American Stock Exchange

on May 8, 1962), for the acquisition of $99,998 shares of IIE, having a book value of $2,007,144 as of January 31, 1962" (139a). In that order it was agreed that the "market value" of Defiance shares was $11.65 per share. Despite the pre-trial order, the trial Judge found the value to be $14.49 per share. When, on motion for re-argument, new counsel called his attention to the pre-trial order, instead of honoring it or stating that he had not considered "market value", the District Judge ordered the parties to supply material on the volume of trading and price of Defiance stock. Interpreting for himself the material thus supplied at his request, the District Judge then found the trading "too thin" to support a "market value". The District Court thus ignored the very stipulation of the parties on the subject, as incorporated into the pre-trial order.

We urge it as a matter of prime and everyday importance that the binding effect of pre-trial orders in the Federal Courts should be upheld by this Court.

Although the Second Circuit had previously upheld the binding effect of pre-trial orders (see *Mull* v. *Ford Motor Co.*, 368 F. 2d 713 [1966]), in the case at bar it made no reference to the problem although the matter had been briefed and argued extensively. The Court of Appeals simply brushed aside the pre-trial order which has been one of the great reforms in the Federal practice.

Cailing for additional evidence was clearly contrary to the general tenor of the rule that "[t]he trial court may not disregard the facts stipulated to *or require evidence to support them.* Rule 16, F. R. Civ. P.; *Laird* v. *Carrier Engine Service,* 5 Cir., 263 F. 2d 948; *Taylor* v. *Reo Motors, Inc.,* 10 Cir., 275 F. 2d 699, 704; *Globe Cereal Mills* v. *Scrwener,* 10 Cir., 240 F. 2d 330; *Berger* v. *Brannan,* 10 Cir., 172 F. 2d 241, cert. denied 337 U. S. 941 . . ." *U. S.* v. *Sommers,* 351 F. 2d 354 (10th Cir. 1965; emphasis ours).

In *Laird* v. *Air Carrier Engine Service, supra,* the Fifth Circuit acknowledged that until a stipulation of fact is

withdrawn with adequate safeguards protecting the party who does not seek its withdrawal, "[i]t is absolutely binding . . . foreclos[ing] the matter altogether" (263 F. 2d at 953). In that case after only *a third* of the trial had been completed the District Court permitted repudiation of a stipulation in the pretrial order allowing the admission of contrary evidence without giving sufficient discovery opportunity to the opposing parties "who came to Court expecting to try one lawsuit found themselves facing something quite different" (263 F. 2d at 952). In the instant case defendants tried the *entire* case without the Court withdrawing or modifying the stipulation that Defiance stock had a "market value". We submit that there was no "manifest injustice" to the plaintiff in enforcing the stipulation, and in fact, it was petitioners who suffered "manifest injustice" since they were held liable for damages of almost $3,000,000 because the pre-trial order was disregarded. See also *Washington State Bowling Properties Ass'n* v. *Pacific Lanes, Inc.*, 356 F. 2d 311 (9th Cir. 1966), cert. denied 384 U. S. 963 (1966).

Moreover, where the stipulation is closely paralleled by the allegations of the complaint, it should be binding on the plaintiff. *Mull* v. *Ford Motor Co., supra.* It has been held that even where a defense is pleaded in the answer, it does not survive where it is inconsistent with a stipulation in the pre-trial order. *Case* v. *Abrams,* 352 F. 2d 193 (10th Cir. 1965). In the case at bar there was no such inconsistency. In fact, the amended complaint, repleaded after the pre-trial order, stated that Defiance stock had a "fair and reasonable value" of $11.50 per share,* but the Second Circuit still disregarded its holding in *Mull.*

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* This is a judicial admission. See *Stolte* v. *Larkin,* 110 F. 2d 226 (8th Cir. 1940); *Gianone* v. *United States Steel Corp.,* 238 F. 2d 544 (3d Cir. 1956); *Peters* v. *Lines,* 275 F. 2d 919 (9th Cir. 1960); *National Marine Engineers Beneficial Ass'n AFL-CIO* v. *N.L.R.B.,* 274 F. 2d 167 (2d Cir. 1960).

For the above reasons we respectfully submit that the purpose of Rule 16 "to save time and expense for the parties, as well as for the Courts" by "carefully drawn and negotiated stipulations" to simplify the issues of fact and to eliminate those not at issue has been violated by the Courts below and should be remedied by this Court in its supervisory capacity. *Mull* v. *Ford Motor Co., supra* at p. 716.

It seems desirable for this Court to emphasize to the District Courts the binding effect of stipulations solemnly incorporated into pre-trial orders.

AS TO QUESTION 3

Scienter must be proved in order for the corporation to recover money damages for violation of §§ 10 and 14 and Rules 10b-5 and 14a-9.

This Court in *SEC* v. *National Securities, Inc.*, 393 U. S. 453 (1969), for the first time chose to review the provisions of Rule 10b-5. The Court did so by comparing Rule 10b-5 with regulations under § 14 in a situation where allegedly false and misleading proxy statements were issued to procure the merger of a life insurance company into National Securities Inc. The factual context of the case at bar is similar to that case, and the issue raised—whether *scienter* must be proved in an action for damages under §§ 10 and 14 and the rules promulgated thereunder—again involves the inter-relationship of these two sections.

The Court in the *National Securities* case said:

> "But the existence or non-existence of regulation under § 14 would not affect the scope of § 10(b) and Rule 10b-5. The two sections of the Act apply to different sets of situations. Section 10(b) applies to all proscribed conduct in connection with a purchase or sale of any security; § 14 applies to all proxy solicitations, whether or not in connection with a purchase or

sale. The fact that there may well be some overlap is neither unusual or unfortunate." (393 U. S. at 468).

In an action for damages, where § 14(a) and § 10(b) overlap, should the requirements for proof of *scienter* differ? The Courts below found petitioners liable for $2,292,940 under the third Cause of Action (§§ 10 and 14) although the Court of Appeals did not find proof of "personal wrongdoing" to be clear.*

Although there is confusion as to the degree of *scienter* required in an action for damages under Rule 10b-5 (see *Globus* v. *Law Research Service, Inc.*, C.C.H. Fed. Sec. L. Rep. ¶ 92,474, p. 98,244 [2d Cir. 1969] and cases cited therein; Bromberg, SECURITIES LAW, §§ 2.6(1), 2.7(1); 6 Loss, SECURITIES REGULATION, pp. 3352-3, 3373), there is general agreement that some degree of guilty knowledge or negligent culpability must be proved (see *Globus* v. *Law Research Service, Inc., supra; SEC* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833 [1968] and concurring opinions).

No Court of Appeals has ruled on the requirement for *scienter* in an action for damages where §§ 10 and 14 overlap, although Judge Mansfield, the District Judge below,** and a recent case in the District Court for the Eastern District of New York*** indicate that *scienter* is not required by § 14.

But this Court in *J. I. Case Co.* v. *Borak, supra* at page 432, apparently indicated that § 14 was aimed at "deceit" which causes *damage* to the corporation when it said:

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* As we have seen, although with respect to pre-judgment interest the Court of Appeals spoke of "calculated fraud" it then remanded to the District Court to make findings on the "personal wrongdoing" of the defendants.

** See *Richland* v. *Crandall*, 262 F. Supp 538, 533 N.12 (S.D.N.Y. 1967), and his opinion in the case at bar (A34).

*** See *Gerstle* v. *Gamble-Skogmo, Inc.*, 298 F. Supp. 66, 97 (E.D.N.Y. 1969)

> "The damage suffered results not from the *deceit* practiced on him alone but rather from the *deceit* practiced on the stockholders as a group." (Emphasis ours)

In talking about "damage" the Court chose to use the word "deceit," which connotes some degree of guilty knowledge (see BLACK'S LAW DICTIONARY, 4th ed. 1951, pp. 493-4)* rather than the words "false and misleading statements" used by Rule 14a-9, which makes no mention of either "deceit" or "*scienter*".

Judge Friendly, concurring in *SEC* v. *Texas Gulf Sulphur Co., supra,* stated that any construction of Rule 10b-5(2) which did not require some proof of fraud would "be so inconsistent with the general structure of the statute as to be impermissible . . ." (401 F. 2d at 868).

There is no reason for a different conclusion in respect of Rule 14a-9. That rule was promulgated by the Commission in 1935 under the authority of § 14 of the 1934 Act before *Borak* held that a violation of the proxy rules gave rise to a private cause of action. The language of the Rule was not specifically intended to determine individual liability for damages but addressed itself to the kind of proxy statement that may not be issued.

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* "To constitute 'deceit,' the statement must be untrue, *made with knowledge of its falsity or with reckless and conscious ignorance thereof, especially* if parties are not on equal terms, made with *intent* that plaintiff act thereon or in a manner apparently fitted to induce him to act thereon, and plaintiff must act in reliance on the statement in the manner contemplated, or manifestly probable, to his injury. Corley Co. v. Griggs, 192 N.C. 171, 134 S.E. 406, 407; Pain v. Kiel, C.C.A.Mo., 288 F. 527, 529. See, also, Crossman v. Bacon & Robinson Co., 119 Me. 105, 109 A. 487, 489; Alpine v. Friend Bros., 244 Mass. 164, 138 N. E. 553, 554; Hood v. Wood, 61 Okl. 294, 161 P. 210, 213.

"The essential elements of 'deceit' are representation, falsity, *scienter,* deception, and injury. Ochs v. Woods, 221 N. Y. 335, 117 N. E. 305, 306." (emphasis ours)

A literal reading of Rule 14a-9 may be applicable in injunction proceedings or even in an action for retrospective rescission (see *Mills* v. *Electric Auto-Lite Company, supra*), but where a private suit for damages is involved, the seller of securities who claims he was defrauded should have the same burden of proving fraud as in his 10b-5 allegation. Otherwise, a 10b-5 violation in a proxy statement would require a more difficult test than a § 14 violation based on the same language in the same document. The reasons of policy which causes the Courts to interpret Rule 10b-5 as requiring a plaintiff to prove some degree of fraud apply equally to proxy violations. Indeed, the language of Rule 14a-9 is stronger —"false and misleading"—than the language of 10b-5(2) —"to make any untrue statement of a material fact." Even though the sections of the Act from which the respective rules derive their authority are different it could hardly have been the Congressional intention or the intention of this Court in *SEC* v. *National Securities, Inc., supra,* to permit the Commission with respect to an action for money damages to make different rules under different sections considering the "general structure of the statute."

Even if the literal language may be used for purposes of injunctive relief or granting rescission, it does not follow that the requirement of *scienter* must be eliminated in actions for damages. This was the way pointed by this Court in *SEC* v. *Capital Gains Bureau,* 375 U. S. 180 (1963), when it noted that it is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages (375 U. S. at 193).

We urge that proof of *scienter,* which would prohibit liaiblity for damages where there has been due diligence, should be required in suits for damages where Rule 14a-9 and Rule 10b-5 overlap.

AS TO QUESTION 4

The careful review by the SEC of the particular proxy statement was erroneously disregarded by the Courts below. All the material facts were disclosed and the particular arrangement of the proxy statement was within the expertise of the SEC. The clearance in such circumstances negates fraud and shows due diligence.

This Court in *J. I. Case* v. *Borak, supra* at 432-433, observed that:

> "The Commission advises that it examines over 2,000 proxy statements annually and each of them must necessarily be expedited. Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representations contained therein at their face value, unless contrary to other material on file with it. Indeed, on the allegations of respondent's complaint, the proxy material failed to disclose alleged unlawful market manipulation of the stock of ATC, and this unlawful manipulation would not have been apparent to the Commission until after the merger."

This passage raises the question of whether a proxy statement can be considered false and misleading, as the Courts below have decided in the instant case, where the Commission has obviously *not* accepted "the representations contained therein at face value" and in fact required changes of position involving the very items found by the District Court to be misleading by virtue of their positioning in earnings or in surplus.

In connection with a proxy statement, Judge Friendly in *General Time Corp.* v. *Talley Industries, Inc.*, 403 F. 2d 159, 163 (2d Cir. 1968), has said, "despite Rule 14a-9(b)

some force can be given to the SEC's clearance of the proxy statement in a case such as this where the omissions were of facts well known to it . . ."

In the case at bar not only were the "facts well known to it," but there were no material omissions and the SEC saw the figures *in the proxy statement itself*. The clearance of the proxy statement by the professional staff, particularly on accounting classification and insurance language, negates any implication that the impropriety was so gross as to make the alleged misclassification of the figures both intentionally deceptive and actually fraudulent. The ambit of fraud cannot reach so far in the case of open disclosure, especially since the instant case presents the *antithesis* of the situation where information "would not have been apparent to the Commission until after the merger". (*J. I. Case* v. *Borak, supra* at 432-3.)

The SEC's failure to object to the form of the proxy statement here concerned the propriety of a given method of insurance accounting and explanations of insurance accounting, a specialized and complex subject on which the SEC has great expertise. The SEC cleared the proxy statement after considering it for almost a year and with complete knowledge of all the material facts which have been challenged.

There may be cases of material omissions or misstatements, where scant comfort can be found in the clearance by the SEC. But where the question is of proper accounting treatment and the like, the Courts have recognized that the expertise of the SEC was involved in the clearance of the proxy statements. *Mack* v. *Mishkin,* 172 F. Supp. 885 (S.D.N.Y. 1959) (where the accounting conflict was whether quarterly earnings were inflated); *Dunn* v. *Decca Records, Inc.,* 120 F. Supp. 1 (S.D.N.Y. 1954) (whether certain payments were reimbursement for expenses rather than compensation to an officer); *Walpert* v. *Bart,* 280 F. Supp. 1006 (D. Md. 1967), affd. 390 F. 2d 877 (4th Cir.

1968) (whether the pro forma cash flow resulting from a prospective merger was properly presented); *Shvetz* v. *Industrial Rayon Corp.*, 212 F. Supp. 308 (S.D.N.Y. 1960) (whether the financial aspects of a proposed merger were properly presented).

The SEC clearance also negates the conclusion that an average investor would have been misled by the juxtaposition of the figures involved. One does not have to say that there was an actual finding to this effect by the SEC. The careful scrutiny by the SEC does dispel the claim, however, that Muscat or Huffines, laymen in accounting matters, should have compelled a rearrangement of the disclosed figures. If the SEC did not insist on a rearrangement of the *disclosed* figures should Muscat or Huffines be punished for not having insisted on just such a rearrangement?

AS TO QUESTION 5

The exchange was not grossly unfair to Defiance or its shareholders.

We submit that a mere glance at the opinion of the District Court after trial indicates that the issues with respect to the Nablico earnings figures in the proxy were irrevocably intertwined in the Court's mind with the issue of fairness. The Court of Appeals merely affirmed these findings without commenting thereon. Had the District Court found, as the SEC apparently did, that the income figures were not false and misleading, and had it given due consideration to the stipulation in the pre-trial order, it might have found that the exchange ratio was fair.

Without arguing the fairness of the exchange at this point, we urge that if the Court grants the instant petition on any of the previous points, to do substantial justice, it should review the finding that the exchange was grossly

unfair. See *Minnesota* v. *National Tea Co.*, 309 U. S. 551, 555 (1940). In the event the petition is granted petitioners will fully brief the issue at that time. In passing, we note that the Court has granted certiorari and has heard argument (October 21-22, 1969) in *U. S.* v. *ICC, Brundage* v. *U. S., and Livingston Anti-Merger Comm.* v. *ICC* (Nos. 28, 38, 43 and 44) which also involve questions concerning the fairness of a ratio where there is an exchange of stock.

CONCLUSION

For the foregoing reasons petitioners pray that this petition for a writ of certiorari be granted.

Respectfully submitted,

MURRAY I. GURFEIN,
Attorney for Petitioner Muscat.

WILLIAM R. GLENDON,
Attorney for Petitioner Huffines.

MEL P. BARKAN,
Of Counsel.

APPENDIX A

Opinion of the United States Court of Appeals.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 545 and 546—September Term, 1968.

(Argued April 23, 1969 Decided September 16, 1969.)

Docket Nos. 32892 and 32893

NORTE & Co.,

Plaintiff-Appellee,

—v.—

R. L. HUFFINES, JR. and VICTOR MUSCAT,

Defendants-Appellants,

—and—

L. F. SERRICK, ALFRED O'GARA, EDWARD KROCK and DEFIANCE INDUSTRIES, INC.,

Defendants.

Before:

LUMBARD, *Chief Judge,*

ANDERSON, *Circuit Judge,* and WYATT, *District Judge.**

Appeal by defendants Huffines and Muscat from a judgment of District Court for the Southern District of New York, Mansfield, *J.*, finding in a derivative stockholders'

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* Sitting by designation.

action that defendants had breached their fiduciary duties to the corporation and that two of the defendants had violated the federal securities laws.

Affirmed.

MILTON PAULSON, New York, N. Y., *for plaintiff-appellee.*

MURRAY I. GURFEIN, New York, N. Y. (Goldstein, Gurfein, Shames & Hyde, on the brief), *for defendant-appellant, Victor Muscat.*

WILLIAM R. GLENDON, New York, N. Y. (Royall, Koegel & Wells, on the brief), *for defendant-appellant, R. L. Huffines, Jr.*

LUMBARD, *Chief Judge:*

The defendants appeal from a judgment of the Southern District of New York against them in the sum of $4,355,595 in favor of plaintiff in a diversity stockholders' action brought for the benefit of Defiance Industries, Inc.

Judge Mansfield found defendants liable for damages because they had breached their fiduciary duties, as the controlling persons in Defiance, in causing Defiance to issue its stock, on July 12, 1962, at a valuation of $14.49 per share in exchange (at a ratio of 4⅞ shares to one) for all the stock of IIE* which he found they valued at the excessive value of $70.51 a share. He found the fair value of IIE stock was $40.58 per share and that the consequent loss to Defiance was $2,992,940. The district court also found that the defendants had improperly appropriated to themselves an opportunity of Defiance to purchase 10,507 shares of IIE by purchasing them at $20.94, and for which

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* Insurance and Industrial Enterprises, Inc.

shares they shortly thereafter received Defiance stock on the basis of IIE stock being valued at $70.51 per share, thus realizing a profit of apportunity $520,832.[1] With the prejudgment interest allowed at 6% from July 13, 1962 on the exchange offer and from September 6, 1961 on the improper appropriation, the judgment totals $4,355,595.

A study of the record shows ample support of Judge Mansfield's findings and his conclusion that in the acceptance of the comparative valuations of Defiance and IIE stock and in the measures that were taken to bring about approval of the Defiance stockholders to the purchase of IIE stock, the defendants acted in violation of their fiduciary duties as controlling officers and stockholders of Defiance. Likewise, there is abundant support for the district court's finding that Defiance had been improperly deprived of the opportunity to acquire, at $20.94 per share, 10,507 shares of IIE for which it later issued stock for IIE valued at $70.51 per share. Nor do we find any basis for error in Judge Mansfield's denial of the motion for a new trial for reasons he set forth in a careful opinion reported at 288 F. Supp. 855 (S.D.N.Y. 1968).

We find only two allegations of error which require comment. Appellants argue that equity requires that under circumstances present here the court should have limited the award of damages to those who were stockholders of Defiance at the time of the exchange of stock.

We can find no reason or precedent to support the theory advanced by the defendants—a theory which is wholly impractical and unmanageable in that it would shift the burden of proving a right of recovery to a large class of persons many of whom may never be determined and found.

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[1] The defendants' liability on these shares is $206,357, calculated by subtracting their liability on these shares under the exchange offer ($314,475) from $520,832.

The corporation by issuing shares to its controlling officers and directors for less than their fair value was obviously damaged to the extent of the difference which was $2,992,940 because it received IIE shares worth only $40.58 per share in return for its shares which were worth $70.51 per share. Under such circumstances those fiduciaries who caused the corporation to part with its assets for less than their fair value must make up the difference to the corporation.

Our decision in *Perlman* v. *Feldmann*, 219 F. 2d 173 (2 Cir. 1955) gives no support to the appellants' suggestion of fragmented judgments. There the plaintiffs were individually injured and sued for injuries caused them by the defendants who sold their controlling stock at a premium without offering plaintiffs an opportunity to sell their stock on similar terms. We held, with Judge Swan dissenting, that the controlling stockholders had breached a duty to the plaintiffs who were minority stockholders for and therefore were liable to the minority stockholders for the premium they would have received had they been included. Thus, in *Perlman* there was no injury to the corporation but only to the few minority stockholders and it was appropriate that they should recover individually.[2]

We conclude that it was entirely appropriate for the court to direct judgment in favor of Defiance for the entire amount of the damages suffered by it.

The appellants also contend that the court should not have awarded pre-judgment interest, amounting to over one million dollars, on so large an award of unliquidated damages. However, as the corporation had been deprived

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[2] In *Perlman* the recovery followed the shares so that in most instances distribution was made to holders of the shares at the time of judgment. See *Perlman* v. *Feldmann*, 154 F. Supp. 436, 446 (D. Conn. 1957).

of almost $3,000,000, the difference between the fair value of the stock issued and what it actually received, through the calculated fraud of the defendants, there was good reason for the district court to award interest *as compensatory damages.* And it is clear that under both New York and Ohio law interest is recoverable for the damages here suffered. See, N. Y. C.P.L.R. § 5001; *In re Chambers Estate,* 160 O. Op. 519, 36 N. E. 2 175 (Ct. App. 1939); *Cincinnati* v. *Whetstone,* 47 Ohio St. 196, 202 (1890). Under the federal cases the award of interest is said to be discretionary, and the authorities indicate that it is customary to award it in cases involving a breach of fiduciary duties. See, *Stell* v. *Graham-Paige Motors Corp.,* 232 F. 2d 299, 302 n. 4 (2d Cir. 1956); *Blau* v. *Mission Corp.,* 212 F. 2d 77, 82 (2d Cir.), *cert. denied,* 347 U. S. 1016 (1954). Judge Mansfield rested his decision to award interest on the "fundamental consideration of fairness," citing *Board of Commissioners* v. *U. S.,* 208 U. S. 343, 352 (1939). We agree that it was wholly appropriate for him to exercise his discretion as he did.

APPENDIX B

Opinion of the United States Court of Appeals Granting Petition for Rehearing and After Rehearing.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 545 and 546—September Term, 1968.

(Decided October 14, 1969.)

Docket Nos. 32892 and 32893

NORTE & Co.,

Plaintiff-Appellee,

—v.—

R. L. HUFFINES, JR. and VICTOR MUSCAT,

Defendants-Appellants,

—and—

L. F. SERRICK, ALFRED O'GARA, EDWARD KROCK and DEFIANCE INDUSTRIES, INC.,

Defendants.

Before:

LUMBARD, *Chief Judge,*

ANDERSON, *Circuit Judge, and* WYATT, *District Judge.**

On Petitions for Rehearing of Defendants Victor Muscat and R. L. Huffines, Jr.

MILTON PAULSON, New York, N. Y., on the brief, *for plaintiff-appellee.*

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* Sitting by designation.

Opinion of the United States Court of Appeals Granting Petition for Rehearing and After Rehearing.

MURRAY I. GURFEIN, Goldstein, Gurfein, Shames & Hyde, New York, N. Y., on the brief, *for defendant-appellant, Victor Muscat.*

WILLIAM R. GLENDON, Royall, Koegel & Wells, New York, N. Y., on the brief, *for defendant-appellant, R. L. Huffines, Jr.*

PER CURIAM:

The petitions for rehearing are granted. We remand to the district court for further consideration of prejudgment interest.

We agree with Judge Mansfield that the Court's discretion in awarding prejudgment interest should be based on fundamental "considerations of fairness." See *Board of Commissioners* v. *United States,* 308 U. S. 343, 352 (1943). But as we said in our original decision, such an award is, in the first instance, compensatory, even though we agree with Judge Mansfield's view that the compensatory principle must be tempered by an assessment of the equities. Compare *Miller* v. *Robertson,* 266 U. S. 243 (1939) with *Ross* v. *Licht* 263 F. Supp. 395 (S.D.N.Y. 1967). We think the district court should give further consideration to whether the prejudgment interest here is compensatory and whether in light of the substantial sum involved it is in accord with "fundamental fairness."

In particular, the district court should make specific findings, first, on the personal wrongdoings of Huffines and Muscat. It also should consider whether Muscat's "forced" sale changes the situations. In making the award, Judge Mansfield may well have been influenced by the fact that Muscat, as a substantial stockholder in Defiance, would indirectly recoup part of the judgment. The trial court might well feel on further consideration, however, that nothing is changed, as Muscat should be

able to receive a price for his shares which reflect the $1,500,000 award.

The district court should also consider whether Defiance was "deprived" of the principal sum so that prejudgment interest can in fact be termed compensatory. It was clearly correct in finding that Defiance suffered damages as a result of the issuance of almost 500,000 additional shares for grossly overvalued consideration. See *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (5th Cir., 1960), cert. denied, 365 U. S. 814 (1960). But in reconsidering its discretionary award, the district court should consider whether Defiance passed up other, reasonably available and attractive opportunities to use these shares to raise cash or to purchase fully-valued assets.

Finally, there is one consideration with respect to the prejudgment interest which was awarded at the rate of 6% which we are not sure the district court passed upon. That is the claim that an unusually long period of time elapsed between the acts complained of, July, 1962, and the trial in February, 1968, with the judgment following promptly in May, 1968. It may well be that the defendants are at least equally responsible for the delay, but if it could be shown that the contrary is true to any substantial degree, it may well be that the district court would find it appropriate to fix the rate of interest at some lower percentage. Also, in awarding interest the district court may well have seen it in part as going to the corporation to cover counsel fees and litigation expenses. This approach would support the salutary principle of making appellants bear the fair cost of the damage they have done, while reserving the principal in its entirety for the corporation.

To permit further consideration of the prejudgment interest award, we grant these petitions for rehearing and remand to the district court, whose judgment stands affirmed in all other respects.

APPENDIX C

Opinion of the District Court After Trial.

[No. 34780]

[SAME TITLE]

Appearances:

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HUGH P. MULLEN, Esq.
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MANSFIELD, D. J.:

This is a consolidated derivative stockholders' suit brought on behalf of Defiance Industries, Inc. ("Defiance" herein), an Ohio corporation formerly named The Serrick Corporation, against certain of its directors for damages for breach of fiduciary duty (first two causes of action) and for violation of § 10(b) and § 14 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78n, and S.E.C. Rule 10b-5 thereunder (third cause of action).* Diversity juris-

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* The text of these statutes and Rule 10b-5 may be found in Appendix A hereto.

diction is invoked as to the first two causes of action (breach of fiduciary duty) and federal question jurisdiction as to the Securities Exchange Act claim (third cause of action).

Although five directors of the corporation are named in the action, the only ones served and before this Court are, R. L. Huffines, Jr. and Victor Muscat. Edward Krock has been served in a similar action pending in the United States District Court for the District of Massachusetts.

Plaintiff attacks two transactions which were authorized and participated in by the individual defendants, allegedly at Defiance's expense:

> (1) The 1962 issuance by Defiance of 487,502 shares of its Class B Voting Stock in exchange for all of the outstanding stock of Insurance and Industrial Enterprises ("IIE" herein), 87% owned by defendants Muscat, Huffines and Krock, pursuant to the said defendants' recommendation valuing the IIE stock at $70.51 per share, which resulted in their acquiring 62% of Defiance's outstanding stock and realizing a profit of approximately $2,703,610* on their own IIE shares; and
>
> (2) The September 6, 1961 acquisition of 10,507 shares of IIE stock (representing approximately 10% of its issued stock) by the triumvirate of Huffines, Muscat and Krock at a price of $20.94 per share, which they then caused Defiance to acquire as part of the aforementioned 1962 exchange at a value of $70.51 per share, realizing a profit of approximately $520,832.

The 1962 exchange is attacked as a self-dealing transaction that was grossly unfair to Defiance and its stockholders

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* Defiance's loss was $2,993,000, resulting in Huffines, Muscat and Krock as 87% owners of IIE, realizing a $2,703,610 profit.

for the reason that it resulted in Defiance's issuance of stock worth $7,050,750 in exchange for IIE stock worth $4,057,759, suffering a loss of $2,993,000 and thereby enabling the triumvirate not only to acquire control of Defiance but to reap a personal profit of approximately $2,703,910. It is further attacked (the third cause of action) on the ground that approval of Defiance's stockholders for the exchange was secured through false and misleading proxy material in violation of §§ 10(b) and 14 of the Securities Exchange Act of 1934 and S.E.C. Rule 10b-5 issued thereunder.

The September 6, 1961 transaction is attacked on the ground that by acquiring the 10.507 IIE shares at $20.94 per share for themselves at a time when they were about to authorize the acquisition of all of IIE's outstanding stock at a value of $70.51 per share, and by later transferring their IIE stock to Defiance pursuant to the exchange offer at the $70.51 price, defendants deprived Defiance of a corporate opportunity to purchase the IIE shares at the lower price and reaped a profit at Defiance's expense.

Following non-jury trial of the action in February 1968, the Court, after reviewing and appraising the evidence, including testimony of witnesses presented by both sides, finds the essential facts to be as follows:

Plaintiff is a co-partnership consisting of Joseph C. Galdi and Rita D. Galdi. Norte & Co. is a stockholder of Defiance Industries, Inc. and has continuously been a stockholder thereof since 1960. Each of the partners of Norte is a citizen and resident of the State of New York.

Each of the individual defendants is a citizen and resident of a state other than New York, as follows:

R. L. Huffines, Jr.	South Carolina
Victor Muscat	Connecticut
L. F. Serrick	Ohio
Alfred O'Gara	Illinois
Edward Krock	Massachusetts

Opinion of the District Court After Trial

Defiance is an Ohio corporation engaged, among other things, in the manufacture of parts for automotive, appliance, oil well and other industries. At all times involved in this suit its Board consisted of five directors, of whom Muscat, Huffines, Serrick, and O'Gara were members,* Muscat holding the office of President and Huffines that of Chairman of the Board. At all times involved Krock was employed by Defiance as a salaried financial constultant. On June 20, 1962, he was added as a sixth director of Defiance. On January 6, 1963, Krock resigned as a director, and on April 29, 1965, he was re-elected a director.

At all times since 1960 the Board of Directors and management of Defiance has been controlled by the triumvirate of Muscat, Huffines and Krock, who prior to 1960 had been associated together in various business ventures, including their acquisition of substantial stock ownership in Defiance itself. By June 1960 they controlled approximately 33⅓% of its outstanding stock, which was the largest single block, following their acquisition of 20,000 shares from O'Gara, who resigned as Chairman of the Board, receiving a five-year contract as a $15,000 per year consultant. Prior to June 20, 1962, Krock received $1,000 per month from Defiance for financial advisory services, and beginning in November 1962 this payment was increased to $25,000 per year for his rendition of such services. Mr. Serrick is a salaried officer of Defiance, serving at will and without any contract of employment. For many years Mr. Joslin has been a friend of Huffines, at whose instance he was nominated as a director of Defiance.

In the summer of 1961 the triumvirate of Muscat, Huffines and Krock, together with their associates, owned over 77% of the outstanding stock of IIE, a Delaware corporation formed in January 1960, the principal asset of which

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* A fifth director, Archie O. Joslin, was not named as a defendant.

was 77% of the outstanding stock of National Bankers Life Insuranee Co. ("Nablico" herein), a Texas insurance company. Huffines, Muscat and Krock constituted three out of IIE's five directors, Huffines being Chairman of the Board and Muscat its President. Huffines and Muscat also held the identical positions in Nablico, of which they and Krock were directors.

To summarize, in the summer of 1961 the triumvirate (Huffines, Muscat and Krock) had working control of Defiance (by virtue of their ownership of 33⅓%), IIE (of which they owned 77%) and Nablico (which was 77% owned by IIE). At that time the trio embarked on a scheme to cause Defiance to acquire all of the outsanding stock of IIE (amounting to 99,998 shares) in exchange for shares of Defiance. The effect of such exchange, depending upon the rate of exchange that would be adopted, would be to solidify the triumvirate's control of Defiance by giving them more than 50% of Defiance's issued and outstanding stock. The plan would also result in giving the stockholders of IIE, which was not publicly traded on any exchange, shares of Defiance which were publicly traded on the American Stock Exchange; and it would also serve to give additional security to certain unsecured IIE notes in the sum of approximately $350,000, which were held by the individual defendants and their associates, as well as to a debt in the sum of $96,750.50 owed by IIE to United Metals Corp., wholly owned by Muscat.

Since the triumvirate controlled the corporations, involved in the proposed exchange, it could not be an arm's length transaction. As a basis for the exchange Muscat retained the firm of Hayden Stone & Co. to appraise the relative values of Defiance and IIE and to recommend a rate of exchange. On June 30, 1961, Hayden Stone rendered its written report, recommending an exchange ratio based on its evaluation of the underlying assets of both

companies. Its appraisal of IUS turned principally on the value to be attributed to IUS's 77% owned subsidiary, Nablico, which was IUS's principal asset. Hayden Stone based its appraisal of this asset largely on unaudited earnings of Nablico for the period from 1956 to 1960 (the most important years being 1958 to 1960), which was supplied to it by Nablico's Comptroller, John P. Redwood, who testified that he arrived at the earnings figures through use of his own admittedly arbitrary adjustments of certain key items (S.M. 47). Substantially the same unaudited Nablico earnings figures were later submitted to Defiance stockholders in the proxy material which solicited approval of the proposed Defiance-IUS exchange, but were not adopted by Peat Marwick Mitchell & Co., a nationally known accounting firm, when it later audited Nablico's books for the years in question in accordance with generally accepted accounting principles, and arrived at very substantially lower earnings for the same years.

Accepting with only minor changes the unaudited earnings figures thus furnished to it by Redwood of Nablico, Hayden Stone capitalized the average of these earnings for the years 1958 to 1960, using both a 14-times and 15-times earnings ratio for the years 1958 to 1960, and adding 25% as a premium for IUS's control of Nablico, which resulted in its placing a value on Nablico's outstanding stock of between $6,362,613 or $72.00 per Nablico share, and $8,991,266 or $78.10 per Nablico share. In addition, although the actual book value of Nablico's assets was $1,490,000, Redwood adjusted the book value upward to $10,950,000 (including 25% additional value for controlling interest), or more than seven times the figure shown on its books, to arrive at a book value of $76.30 per Nablico share which was furnished to Hayden Stone and used by it in evaluating IUS's shares of Nablico stock.

The Hayden Stone report, dated June 30, 1961, used the above-mentioned figures submitted by Redwood to appraise the total IIE assets as ranging from $6,751,685, or $67.52 per IIE share, to $7,350,338 or $73.50 per share, an average of $70.51 per share, which was recommended as the basis for exchange with Defiance's stock at $14.49 per share. This appraisal resulted in an exchange ratio of 4⅞ shares of Defiance Class B Common Voting stock for each share of IIE stock, or 487,502 shares of Defiance stock for 99,998 shares of IIE stock, which was adopted by Defiance's Board of Directors on September 12, 1961, as the basis for an exchange that would be submitted to Defiance's stockholders for approval. Present and voting in favor of the recommendation at the September 12, 1961 Defiance Board meeting were Huffines, Muscat, Serrick and O'Gara. The exchange offer was promptly accepted by every stockholder of IIE, each agreeing to tender his IIE shares at the proposed ratio. However, due to difficulties and delays in obtaining SEC review of the proxy material to be sent out to Defiance's stockholders, the cut-off date in the agreements between Defiance and IIE expired and the agreements lapsed.

In the meantime on September 6, 1961, although the proposed exchange ratio placed a value of $70.51 on the IIE stock to be acquired by Defiance, the triumvirate (Muscat, Huffines and Krock) purchased 10,507 IIE shares from Andrew D. Griffith, then a director of IIE, for $20.94 per share in an arm's length transaction which was negotiated in hard bargaining fashion over a period of some weeks. These 10,507 shares represented more than 10% of IIE's 99,998 outstanding stock. The transaction was consummated more than two months after submission of the Hayden Stone report on June 30, 1961, and one week prior to the adoption by Defiance's Board of the resolution recommending its acquisition of all of IIE's stock (including 10,507

shares) at a value of $70.51 per share. Since the triumvirate controlled Defiance's five-man Board, the inference is irresistible that at the time of the purchase of the 10,507 shares from Griffith, i.e., on September 6, 1961, the triumvirate were well aware that the proposed exchange would be approved by the Board for submission shortly to Defiance's stockholders.

Although the negotitions for purchase of the 10,507 IIE shares from Griffith were handled principally by Krock and took the form of a transfer of the shares from Griffith to Krock who in turn transferred 3,502 IIE shares to Huffines, 1,751 shares to Muscat and 1,751 shares to Muscat's mother, and retained 3,503 shares for himself, the evidence is clear that Krock was acting on behalf of the triumvirate in making the purchase. The three had been associated together in various ventures over a period of several years. In the spring of 1960, for instance, acting as a group they had acquired their one-third interest in Defiance. They had likewise acted together in the formation of National Bankers Investment Co. ("NBIC" herein), the predecessor of IIE, which they formed to acquire control of Nablico. Huffines, who had known Krock since 1945 in various business dealings (some involving Muscat), brought in Krock as a partner in the IIE venture. From this close joint association in numerous prior similar ventures, it must be inferred that the triumvirate were acting together in the immediate transaction and a sufficient foundation was thus established to permit introduction of Krock's own testimony to the effect that in negotiating with Griffith for the purchase of the 10,507 IIE shares, Krock was acting for the group consisting of Huffines, Muscat and himself, and that he confirmed the deal with Griffith only after telephoning Huffines and Muscat and obtaining their approval. Krock's agency for the group is further confirmed by his letter to Griffith dated August 16, 1961 to the effect that

if he purchased the IIE stock he would offer his shares to his "partners," referring, of course, to Muscat and Huffines, and by the further fact that within a few days after acquiring the 10,507 shares from Griffith for $20.94 per share he transferred a one-third interest each to Huffines and Muscat, respectively, at his own cost price of $20.94 per share.

Even if defendants' contention that Defiance lacked cash to take advantage of the corporate opportunity offered by Griffith had legal validity, which is doubtful, *Irving Trust Co.* v. *Deutsch*, 73 F. 2d 121 (2d Cir. 1934); *Mainhard* v. *Salmon*, 249 N. Y. 458 (1928), there is insufficient proof to support it. There is no showing, for instance, that the opportunity was ever offered to Defiance, much less rejected by it for lack of cash. Defiance's balance sheet reveals that it had current assets of more than $3.2 million shortly prior to the transaction, including almost $1 million in cash and $1 million in net current receivables, against total current liability of approximately $2 million. In May and June 1961 Defiance apparently had had no difficulty paying a total of $1,194,300 in cash for 320,000 shares of Utronics Corp. Compared with such an acquisition the $220,000 required to purchase 10,507 IIE shares from Griffith would have represented but a modest outlay.

The Court also rejects defendants' contentions (1) that the Griffith-Krock transaction represented a distress sale by Griffith, and (2) that Krock paid additional consideration to Griffith by giving up an option to participate with Griffith in a Florida hotel venture. It is true that Krock did pay part of the $220,000 purchase price by cancelling Griffith's outstanding note held by Krock in the sum of $100,000 (due November 15, 1961), given earlier in the year against an advance in that amount by Krock to Griffith to acquire a Florida hotel property. However, Krock was not pressing Griffith for payment of the note. On the contrary

he was willing to extend the note indefinitely and it was Griffith who sought to discharge the obligation in advance of the due date, which was November 15, 1961. As for the so-called "option" it amounted to no more than an offer by Griffith to Krock to participate in the Florida hotel venture, which Krock refused. There is no evidence that the opportunity to participate in the venture had any value. As far as the record is concerned, it may have involved Krock in liabilities.

The triumvirate's purchase of 10,507 IIE shares on September 6, 1961, for $20.94 per share not only represented a corporate opportunity that should have been offered to Defiance, but it also evidences the gross unfairness of the defendants' recommendation that Defiance purchase all of IIE's stock (including the 10,507 shares) at a value of $70.51 per share, since it reveals that in their own dealings these knowledgeable buyers and seller (Griffith), each of whom was aware of the figures in the Hayden Stone report, did not honestly believe that the report, and the unaudited figures furnished as the basis for its appraisal, fairly stated the value of the outstanding stock of Defiance and IIE. For instance, when the Hayden Stone report was advanced by Griffith and his representative Pruitt as the basis for evaluating IIE stock, Krock advised them that the report showed a "grossly inflated value" for the IIE stock, and that it contained "flaws." Likewise Huffines advised Griffith that the report was "not reliable" and could not be used as the basis for evaluating IIE stock. Despite the Hayden Stone report and Griffith's initial demands for a higher price, the parties, after hard bargaining, finally arrived at a price of $20.94 per share which both Muscat and Huffines considered to be a fair price.

At the time of the purchase of the 10,507 shares at $20.94 per share, the book value of the IIE stock was approximately $21.00 per share.

Notwithstanding the fact that the trio had thus acquired 10% of IIE's outstanding stock at $20.94 per share, Huffines and Muscat proceeded with their recommendations to the stockholders of Defiance that all outstanding IIE stock, including the 10% just purchased by them, be acquired pursuant to an exchange arrangement which valued the IIE stock at $70.51 per share, and on September 12, 1961 (six days after the purchase of the 10%) Defiance's Board adopted the resolution recommending the Definance-IIE exchange on such a basis.

Because of delays in obtaining SEC review of the necessary proxy material, the Board's September, 1961 recommendation could not be implemented prior to the cut-off dates agreed upon by the parties. Accordingly, on May 15, 1962, Defiance's Board, including Muscat and Huffines, called a meeting of its stockholders to be held on June 20, 1962, to approve the proposed exchange at the original ratio and original $70.51 per share valuation placed on the IIE stock.

On May 28, 1962, pursuant to the aforementioned recommendation, Defiance's Board caused an 80-page detailed proxy statement to be issued recommending the exchange to Defiance's stockholders at the ratio of one share of IIE stock for 4⅞ shares of Defiance stock. A great deal of the mass of detail found in this proxy statement would be difficult, or course, for the average stockholder to read, much less to understand. Much of it is devoted to fine print financial descriptions, statements and items peculiar to the insurance business.

Even an intelligent stockholder seeking the true picture would be disappointed, however, for the reason that the proxy statement misstates certain key material facts, and omits others, with the result that it would mislead him into the belief that the exchange ratio was a fair one, whereas he could be led to a contrary impression by disclosure of the actual facts. One of the most serious of these misleading

statements arises out of the proxy statement's use of unaudited, inflated earnings figures for Nablico, IIE's principal asset, for the years 1958 to 1960, which were substantially in excess of Nablico's actual earnings for those years, as certified by Peat Marwick Mitchell & Co. after audit for use in Nablico's September 1962 prospectus. The materiality and misleading nature of the unaudited figures, which were furnished by Redwood of Nablico pursuant to Muscat's direction, is evidenced by the fact that substantially the same unaudited, inflated figures were used by Hayden Stone, to whom they were furnished by Redwood, to arrive at an appraisal of IIE's stock of $70.51 per share, though capitalization of Nablico's earnings by use of "times-earnings" multipliers of 14 and 15, and the same distorted figures could be expected to have a similar influence on Defiance's stockholders, some of whom might resort to the common practice of capitalizing earnings to arrive at the value of IIE shares for purposes of determining whether the exchange ratio was fair. A comparison of Redwood's unaudited and uncertified earnings figures for the years 1958 through 1961 with the audited earnings certified by Peat Marwick Mitchell & Co. as being in accordance with generally accepted accounting principles reveals that Peat Marwick found the earnings for these years to be $595,131 less than the earnings represented in the proxy statement:

	May 1962 Proxy Statement (Unaudited)	Sept. 1962 Nablico Prospectus (Audited and Certified by Peat Marwick Mitchell & Co.)
1958	$ 486,958	$ 346,011
1959	673,225	388,469
1960	568,417	358,800
1961	369,413	408,602
Total	$2,098,013	$1,501,882

The differences between the higher unaudited, uncertified earnings figures used by the defendants in the proxy statement and the lower figures certified by Peat Marwick Mitchell & Co. after audit arise for the most part out of the treatment of various adjustments made in later years to earnings for earlier years, as reported to various state insurance departments. Instead of making the adjustments by deduction from the income figures for the earlier years, as dictated by generally accepted accounting principles used by Peat Marwick Mitchell & Co., defendants improperly showed the changes as adjustments to unassigned surplus. Redwood testified that upon learning the final earnings for an earlier year, he followed the latter course for the reason that this was a procedure used in reporting to various state insurance departments. Unlike Defiance's stockholders, however, such departments were more interested in whether assets were sufficient to meet policy claims than in obtaining an accurate statement of earnings for any given year. Since the multi-state insurance forms used in reporting to state insurance departments contained no provisions for allocating earnings and expenses to proper time periods, as required by generally accepted accounting principles, but were satisfied with a balance sheet, asset type of disclosure, correction of earnings figures for earlier years was not made but was reflected by adjustment to unassigned surplus.

Stockholders being solicited to approve the Defiance-IIE exchange were entitled to an accurate statement of Nablico's actual earnings for the years immediately preceding 1962, and it was misleading to provide them instead with a statement that improperly included substantial and material items as income when in fact these items were not income. If a reasonable difference of opinion existed between accountants as to whether the items constituted income, their treatment as such in the proxy statement might be excusable, provided the stockholders were given some inkling of

the diversity of opinion. In this case, however, no such diversity of opinion existed. Irving Kuller, a Certified Public Accountant with more than 30 years experience, a partner in a large and reputable firm of Certified Public Accountants (David Berdon & Co.), testified:

> "Q. Does this diversity of opinion also apply in the area of insurance accounting as compared perhaps to industrial company accounting?
>
> "A. The word 'diversity' is something which slows me up in answering the question. I don't know what you mean by 'diversity.' If you mean that accountants may differ in the determination of whether a particular item of expense or liability should be treated in one fashion or in another, yes, they could have differences of opinion.
>
> "With respect to the items involved in the adjustments of income as certified by Peat Marwick Mitchell, I am not aware of any diversity of opinion with respect to the adjustments they made because their certificate is unqualified and the footnotes to their financial statements do not signify or suggest that a diversity of opinion existed."

The use in the proxy statement of the method used by Nablico in reporting to state insurance departments, rather than generally accepted accounting principles which required prior-year corrections to be made to earnings figures, not merely to unassigned surplus, was the principal cause of the distortion of Nablico's earnings, accounting for $310,917 of the total inflation of the 1957 to 1961 earnings figures. Thus the item "increase in prior years' life reserves," a correction to life reserves made on the basis of actual end-year experience with claims on life policies as ascertained in the following year, which amounted to

$106,389 for 1957, $65,061 for 1958, and $40,000 for 1959, was reported in the proxy statement as a deduction from unassigned surplus rather than as a reduction in net income for the appropriate year in accordance with generally accepted accounting principles used by Peat Marwick Mitchell & Co. Similarly, certain accounts receivable, $63,131 for 1958 and $36,336 in 1960, which were considered uncollectible, were subtracted by Peat Marwick Mitchell & Co. from net income for those years but were reflected in the proxy statement in the unassigned surplus statement, not in the statement of earnings.

The failure to make such adjustments to earnings, as required by generally accepted accounting principles, is all the more glaring a distortion because Redwood, who was responsible for preparation of Nablico's financial statements for the proxy statement, was undoubtedly aware of the adjustments to earnings actually made by Peat Marwick Mitchell & Co. in accordance with generally accepted accounting principles, since he had been working closely with them on various matters including these adjustments from at least as early as 1960.

Other differences between the high unaudited figures used in the proxy statement and the lower figures certified by Peat Marwick Mitchell & Co. do not result from the proxy statement's showing adjustments in the unassigned surplus statement rather than to earnings but from its failure to reflect adjustments to earnings in the appropriate year. A significant example of this type of distortion was the inclusion in 1958 earnings of $197,725 which should have been included in 1957 earnings. This amount represented income from a co-insurance arrangement which was not reported by the writer of the insurance (in which Nablico shared) until after Nablico's 1957 financial statements were prepared. It was thereupon routinely included in 1958 earnings without ever properly crediting it to 1957 earnings,

which created the erroneous impression that Nablico's 1958 income was higher than it actually was. Later, when new federal tax legislation on underwriting income made allocation of income between 1957 and 1958 important for tax purposes, Redwood searched Nablico's financial history and "somewhere in 1962" discovered this adjustment in time for inclusion in the September 1962 statements certified by Peat Marwick Mitchell & Co. In view of Redwood's testimony that he commenced working with Peat Marwick Mitchell & Co. on the problems created by the new tax legislation at least as early as 1960, it may fairly be inferred that the "discovery" of this adjustment was made in time for inclusion in the May 1962 proxy statement as well. The omission of this adjustment from the proxy statement, with the resulting erroneous presentation of this item as 1958 rather than 1957 income, is significant not only because of its magnitude, but also because 1958 was the first year in which Nablico was under the control of Huffines, Muscat and Krock.

Regardless of what may have been the specialized interest of state insurance departments, Defiance's stockholders were entitled, in voting upon the fairness of the proposed Defiance IIE exchange, to an accurate statement of the earnings of the two companies, especially since such earnings could play an important part in determining the fairness of the exchange ratio. Instead they were furnished with figures that were materially misleading, since they gave the impression that over the four-year period, 1958 to 1961, Nablico, IIE's principal asset, had earned $596,131 more income than would actually be reflected through the application of generally accepted accounting principles.

The material significance of the difference between IIE's true earnings as reported by Peat Marwick Mitchell & Co. and the inflated, unaudited and uncertified figures incorporated in the proxy statement, is illustrated by the fact

that when Hayden Stone's capitalization of earnings formula (14 to 15 times earnings) is applied to Peat Marwick's statement of Nablico's earnings for the years 1958 to 1960 (the same years used in the Hayden Stone report, which formed the basis for the recommendation to Defiance's stockholders), it reveals that Defiance overpaid $3,383,415 in its own stock (at $14.49 per share, as valued by Hayden Stone) for all of the outstanding stock of IIE. Mr. Kuller of David Berdon & Co. testified that application of the identical Hayden Stone formula to the Peat Marwick earnings figures would have required Defiance to issue 254,000 shares of its Class B Common Stock for acquisition of all shares of IIE instead of the 487,502 Defiance shares issued by it, or a difference of 233,500 shares. To put it another way, use of Peat Marwick's certified statement of earnings for the years 1958 to 1960 would have resulted in an average value of $36.68 per IIE share instead of the value of $70.51 per IIE share arrived at by Hayden Stone.

In addition to its inflation of Nablico's earnings, the proxy statement contains other misleading items, distortions and omissions, as follows:

(1) *The representation that there was no market in IIE stock when the triumvirate had recently purchased 10% of IIE's outstanding shares at $20.94.* Even if the average stockholder did not attempt to read all of the fine print contained in the proxy statement, one item which he would be most likely to read would be the Board's Recommendations, which are found at page 10. Of obvious central importance to a stockholder deciding whether to approve the exchange at the recommended ratio would be the price at which the shares of each company involved had recently been sold. In the case of Defiance, which was publicly traded on the American Stock Exchange, its market range was not only known to many of its stockholders, but it was set forth by quarters in the proxy statement for the two-

year period prior to May 24, 1962. Likewise the over-the-counter price range of Valhice common stock was stated by quarters for the same period. With respect to the price of the IIE stock, however, one finds under the "RECOMMENDATION OF THE BOARD OF DIRECTORS" the following statement (p. 10):

> "There is no market for the stock of Insurance and Industrial Enterprises, Inc. since all of the stock of that concern has been held by only a small number of persons."

Turning to that part of the proxy statement headed in block print "PRICE RANGE OF CLASS B COMMON STOCK OF THE SEBRICK CORPORATION [Defiance]" and "PRICE RANGE FOR THE COMMON STOCK OF NATIONAL BANKER'S LIFE INSURANCE COMPANY," the price ranges for the shares of these two companies are listed in detail, followed by the statement:

> "Since all the stock of Insurance and Industrial Enterprises, Inc. is held by only a small number of persons, there has been no market for its stock."

If, instead of stating that there was no market at all for IIE shares, the proxy statement had revealed under these headings the fact that within the previous 10 months (and only a few days prior to the Board's first recommendation favoring the exchange) approximately 10% of IIE's issued stock had been sold in an arm's length, hard bargain for $20.94 per share, which was approximately the book value shown on IIE's books, the average stockholder may well have been influenced to conclude that the proposal to issue 4⅞ shares of Defiance, valued at $70.51, for each share of IIE stock was a most unfair exchange from his standpoint.

The vital information—the recent sale of a substantial block of IIE shares for $20.94 per share—was not disclosed in a meaningful location in the proxy statement, where one

might reasonably expect to find it. Instead it was buried as a tailend reference under a subheading of a section entitled "DESCRIPTION OF INSURANCE AND INDUSTRIAL ENTERPRISES, INC.", which does not purport to deal with the prices at which IIE stock had been sold in a recent transaction. The subheading, which is entitled "Principal Owners of Stock," purports initially to describe the names of the principal owners of more than 10% of IIE's outstanding common stock and refers to the September 1961 transaction for $20.94 per share only at the very end of the text where it would be least likely to be noticed by a stockholder.

(2) *The failure of the proxy statement to state plainly, as did the Hayden Stone report, that Nablico's declining volume of life insurance had the effect of giving a distorted picture of earnings.* Earnings in the insurance business appear to be less in periods of growth (which involve greater initial acquisition costs) than in periods of decline. Nablico's volume of life insurance had declined from $84 million in 1957 to $58.7 million in 1960, which had the effect of temporarily showing high earnings that did not reflect a true picture of its condition. Instead of flatly so stating, as did the Hayden Stone report, the proxy statement engaged in a type of circumlocution that would require an extraordinarily perservering and persistent stockholder to figure out the actual fact. This was accomplished by the device of fragmentation, i.e., separately inserting piecemeal statements with respect to the matter in different locations in the statement. For example, in one location it is asserted generally that in insurance accounting certain expenses are not accrued in relation to the period during which earnings are received and that such prepaid expenses may not be carried as an asset, with the result that when the number of policies being issued exceeds those being terminated, statutory earnings are reduced to the extent of the increase in prepaid acquisition costs, whereas "In a period when the

reverse is true, statutory earnings are benefited." The trouble with such generalities is that while they might lead an extraordinarily able and inquiring stockholder to apply them to figures supplied elsewhere in the proxy statement, the average stockholder reading the statement could not be expected to go through such a tortuous and difficult process. The effect was to skillfully mask the overstatement of Nablico's earnings instead of stating plainly that the decrease in life insurance in force had the effect of causing an overstatement in earnings.

(3) *The proxy statement's failure to reveal that a $5,500 judgment had been rendered against Nablico in a suit by two policyholders against it claiming dividends and that substantial amounts were involved in similar claims being asserted by other Nablico policyholders.* Such a statement was made in Nablico's later registration statement of September 1962. However, the proxy statement, while stating as a contingent liability that Nablico was a party to six lawsuits involving claims by policyholders, merely asserted that "in the opinion of counsel, the claims are not justifiable", without disclosing that Nablico had already lost an earlier lawsuit involving such claims and that additional claims for substantial amounts could be anticipated if the six pending suits were not determined favorably to Nablico. In fact, up to March 1965 Nablico had disbursed approximately $162,000 in settlement of such claims and additional claims remain undetermined.

Plaintiff contends that the proxy statement, in addition to the above misstatements and omissions of material facts, was false, misleading and deceptive in that (1) it failed to inform Defiance's stockholders how the exchange ratio recommended by Defiance's Board was arrived at, i.e., through an independent appraisal which applied certain "times-earnings" multipliers to earnings figures, and then added a 25% premium for IIE's control of Nablico, taking

into account certain disadvantages in Nablico's operations; and (2) it gave the erroneous impression, by comparing recent market prices of Defiance and Nablico shares, that the 1 to 4⅞ ratio of exchange was directly related to a comparison of those market prices when such was not the fact. If other material facts (noted above) had not been misstated or omitted, these items would not be of material significance. Although it would have been helpful to the stockholders to be informed of the fact that a 25% premium was included for IIE's control of Nablico in arriving at the recommended exchange ratio, it was unnecessary to furnish them with a copy of the Hayden Stone report or the details of that report, provided the facts disclosed had not been distorted or misrepresented. As for the second contention, the proxy statement did not create the false impression that the exchange ratio was directly related to the market prices of Defiance and Nablico stock, because the presentation of market prices of Defiance and Nablico shares was clearly limited solely to those two companies. The evil, however, lay in the failure to reveal in the same context that more than 10% of IIE shares had recently been sold in an arm's length transaction at $20.94 per share rather than bury such a vital fact in the tailend of an irrelevant portion of the long proxy statement.

Following the distribution of the misleading proxy statement to Defiance's stockholders, the exchange of IIE shares for Defiance shares was approved by more than two-thirds of the issued and outstanding stock of Defiance at a meeting held on June 20, 1962. The shareholders of IIE unanimously accepted the exchange offer and tendered their IIE shares at the approved ratio of 4⅞ shares of Defiance stock for each share of IIE. As a result Defiance, in the summer of 1962, issued 487,502 shares of its Class B common stock in exchange for all of the outstanding shares of IIE. Of the Defiance shares thus issued, 375,857 shares were issued to Muscat, Huffines, Krock and their associates, with the re-

sult that the triumvirate increased their ownership Defiance stock to 420,157 shares or 62.1% of its outstanding stock, which clearly represented voting control as compared with the working control theretofore possessed by them.

The gross unfairness to Defiance's stockholders of the exchange, and the materiality of the distorted and inflated Nablico earnings figures contained in the proxy statement distributed to Defiance stockholders for the purpose of inducing them to approve the exchange, is further evidenced by the fact that in November 1962 Huffines commenced arm's length negotiations with third parties (John B. Schary Company) for the sale of IIE's stock interest in Nablico, which was IIE's principal asset, leading to the execution of a sales contract on February 4, 1963, which was consummated by IIE's sale of its Nablico shares to the third parties for a price of $5,495,835, or $49.50 per Nablico share, as compared with Hayden Stone's evaluation of the Nablico shares as worth from $72.90 to $78.10 per share as the basis for its evaluation of IIE in connection with the Defiance IIE exchange.*

Accepting Hayden Stone's valuation of IIE's assets other than its Nablico shares (which were its principal asset), and substituting the actual price realized by IIE of $49.50 per Nablico share, the aggregate net value of IIE's own

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* The February 4, 1963 contract (Ex. 21) called for a net price of $4,162,227 for sale of IIE's Nablico shares, consisting of (1) $3,900,872 cash (2) the buyer's assumption of $585,000 in obligations plus accrued interest of $17,355; and (3) the buyer's non-negotiable two-year promissory note in the sum of $1,166,707, from which must be deducted (a) $516,707 because the note was compromised for $650,000; and (b) $100,000, a reserve established for loss on certain real estate purchased by Defiance from Nablico pursuant to the contract. Adding to the resulting net price of $4,162,217 a cash dividend of $1,333,608, which IIE received from Nablico on July 18, 1962, results in a total purchase price received by IIE of $5,495,835 or $49.50 per share (based on 111,138 Nablico shares owned by IIE before a 100% stock dividend on June 14, 1962).

outstanding stock was $40.58 per share rather than the $70.51 per share attributed to it by Hayden Stone as the basis for the defendants' recommendations to Defiance stockholders that resulted in approval of the exchange at the stockholders' meeting of June 20, 1962.

Although the parties have stipulated in the pre-trial order that IIE's sales of its Nablico shares pursuant to the negotiations commenced by Huffines in November 1962 was "determined by arm's length negotiations between IIE and the purchaser," Redwood suggested in his testimony that IIE's sale of its Nablico shares was a forced sale arising out of Defiance's need for money. This opinion, however, is unsupported by any credible evidence.** The negotiations extended over a period of approximately three months, culminating in the February 4, 1963 contract. There was no decline in Nablico's business after March 1961, when Redwood submitted to Hayden Stone his "adjusted book value" figures for use in determining the value of the Nablico and IIE shares. Furthermore, Huffines, the principal negotiator, testified that the negotiation for the sale of Nablico "was a very hard and arm's length negotiation of trying to get the best price on our part and the best price on his part."

** For instance, Huffines' testimony that IIE was willing to sell for a lower price because of the "worsening of the litigation" instituted by Nablico policyholders, who had become "militantly aggressive" in their suits for dividends, is hardly consistent with the earlier statement in the May 28, 1962 proxy statement to Defiance's stockholders that "in the opinion of counsel, the claims are not justifiable." As for Huffines' testimony that the Texas Department of Insurance was requiring larger reserves, this step appears to have been precipitated by Nablico's distribution of a dividend of $1,133,608 on July 18, 1962, which is taken into account in arriving at the price of $49.50 per Nablico share.

After thoroughly reviewing the evidence the Court finds that the fair market value of IIE's Nablico shares on June 20, 1962, when Defiance's stockholders approved the Defiance-IIE exchange, was $49.50 per share and that the fair market value of IIE's outstanding stock on that date was $40.58 per share.

Conclusions

This Court has jurisdiction over the person of defendants Defiance, Muscat and Huffines, and over the subject matter of the action.

Plaintiff has established a clear case of gross and deliberate fraud on the part of defendants Huffines and Muscat, knowingly participated in by Krock, in breach of their fiduciary duties to Defiance's stockholders and with the purpose and effect of profiting at the expense of its stockholders. It is difficult to conceive of more flagrant and callous breaches of trust on the part of corporate fiduciaries than those found here. At the very time when defendants were recommending to Defiance stockholders the acquisition of IIE stock at a value of $70.51 per share, they were privately acquiring for themselves a very substantial block of that stock (10%) at $20.94 per share in an arm's length transaction with a seller fully acquainted with the facts, all with a view to turning the block over shortly to Defiance in exchange for Defiance stock worth $70.51 for each IIE share turned in by them to Defiance. Later they consummated this unconscionable transaction, realizing a profit of $520,932 at the expense of their stockholders.

As Defiance's directors and principal executive officers, Huffines and Muscat owed the fiduciary duty to make available to Defiance the opportunity to purchase the 10,507 shares of IIE stock at $20.94 per share. For their violation of that duty they are jointly and severally liable to De-

fiance for $520,832 (the difference between the value of the Defiance shares (at $14.49 per share) received in exchange for the 10,507 IIE shares ($740,848) and their cost of acquiring the 10,507 IIE shares ($220,016)) less $314,475 (the amount for which defendants are liable on Counts I and III with respect to these shares), or $206,357.

Their liability extends not only to the 7,004 IIE shares acquired by them but also the 3,503 shares acquired by Krock. Just before selling the 10,507 shares to Krock, Griffith offered to sell the entire lot to Huffines, who wrongfully seized this corporate opportunity to acquire all 10,507 shares by purchasing 3,502 shares through Krock, a long-time joint venturer with Huffines and Muscat in various enterprises, including their acquisition of working control of Defiance and exercise of that control. Accordingly, Huffines is individually liable with respect to all 10,507 shares, regardless of the fact that he split with his partners, Krock and Muscat, the opportunity to acquire them. Furthermore, Huffines and Muscat are liable, jointly and severally with Krock, with respect to all 10,507 shares because the liability of fiduciaries who act together in breach of their fiduciary obligations is joint and several, *Irving Trust Co.* v. *Deutsch,* 73 F. 2d 121, 125 (2d Cir. 1934), *Austrian* v. *Williams,* 103 F. Supp. 64 (S.D.N.Y.), *rev'd on other grounds,* 198 F. 2d 697 (2d Cir.), *cert. denied,* 344 U. S. 909 (1952), and Krock himself owed a fiduciary duty to Defiance not to convert its corporate opportunity to his own use. In September 1961 Krock was a "financial consultant" to Defiance and, although not then a director, his fiduciary obligation to Defiance arose from his joint participation with Huffines and Muscat in the exercise of control of Defiance.

> "It is the fact of control of the common property held and exercised, not the particular means by which or manner in which the control is exercised, that

creates the fiduciary obligation." *Southern Pac. Co.* v. *Bogert*, 250 U. S. 483, 492 (1919).

Accordingly, Huffines and Muscat, having acted jointly with Krock in breach of their fiduciary obligations, are responsible not only for their own breaches of trust, but also for that of their co-venturer, Krock.

Huffines and Muscat are likewise guilty of a violation of §§ 10(b) and 14 of the Securities Exchange Act of 1934 (third cause of action) in fraudulently misrepresenting material facts to Defiance's stockholders in the May 28, 1962 proxy statement, including the 1958 to 1960 earnings of Nablico, and in omitting from the proxy statement material facts that rendered it misleading. As a proximate result of their misconduct, Defiance stockholders approved the Defiance-IIE exchange at the ratio of 1 share of IIE stock for 4⅞ shares of Defiance stock, worth $70.51. The effect was to require Defiance and its stockholders to pay $70.51 per share for IIE shares worth $40.58, or an excess of $29.93 per share. Huffines and Muscat accordingly must be held liable for this excess amounting to $2,992,940.

Although actual knowledge is not essential to the establishment of a claim based on § 14(a) of the Exchange Act, the Court concludes that Huffines and Muscat, two knowledgable and experienced business executives in charge of Nablico's affairs, were aware of its true earnings. Both had acted together in the formation, control and disposition of numerous companies for many years, including Nablico. They were, respectively, Chairman of its Board of Directors and President, and had been in control of Nablico since 1958. Muscat had been responsible for the hiring of Redwood as a Vice-President and Controller in charge of the preparation of Nablico's financial statements, and Redwood was the source of the financial data used by Hayden

Stone and it was at Muscat's suggestion that Redwood spoke with a representative of Hayden Stone concerning methods to be used in the valuation of Nablico, including prior-year adjustments to statutory earnings figures. Furthermore, concerning the failure of the proxy statement to disclose that two of the policyholders claiming dividends had recovered judgment and that substantial amounts were involved in similar claims against Nablico, it is clear that Huffines and Muscat knew that Nablico had already lost one such suit and that additional claims in substantial amounts could be anticipated. Huffines stated that the matter of policyholder suits was considered and discussed with the Texas Insurance Department prior to June, 1962 and Muscat admitted that as early as June, 1962 he estimated the maximum liability on such claims to be $250,000, although no indication of the seriousness of these suits appears in the proxy statement. Muscat's testimony that he was told by counsel that the adverse judgment resulted from counsel's failure to duly appeal the decision of a judge who "didn't quite understand the case" does not alter the fact that he and Huffines knew of the adverse judgment and of the probability of substantial additional claims, facts which should have been disclosed in the proxy statement.

Huffines and Muscat are liable for the excessive amount of $2,992,940 which Defiance was required to pay for the IIE shares for the additional reason that they acted in violation of their state-law fiduciary obligation to Defiance (first cause of action) by causing it to acquire all the stock of IIE, 77% owned by them and their associates, at an inflated price. It is no defense to this breach of fiduciary duty that Defiance's stockholders ratified the defendants' self-dealing transaction since that ratification, having been procured by fraud, is ineffective. *Claman* v. *Robertson*, 164 Ohio St. 61, 28 N.E.2d 429, 436 (1955).

"It would thus appear, both on reason and authority, that a disinterested majority of the shareholders of a corporation have the power to ratify directors' frauds *provided there is no actual fraud in either inducing or effecting such ratification.*"* (Emphasis supplied)

In accord: *Berkwitz* v. *Humphrey*, 163 F. Supp. 78, 93-94 (N.D. Ohio 1958).

Nor does the fact that Hayden Stone recommended the exchange ratio afford defendants any legal protection. That report was founded on substantially the same inflated Nablico earnings (furnished to it by Redwood) as those later used by the defendants in the Defiance proxy statement to induce its stockholders to approve the exchange. Furthermore, since Hayden Stone submitted its report in June 1961, it could not have had knowledge of the arm's length transaction for sale of 10% of the IIE stock negotiated only a couple of months later at a price of $20.94 per share instead of the $70.54 recommended by the report.

This most crucial information, coupled with more accurate earnings data, would undoubtedly have led Hayden Stone to reconsider and revise its report and recommendations. Furthermore, both Huffines and Muscat at the time when that sale was being negotiated took the position that the Hayden Stone report was of no significance and "that it couldn't be used for any basic pricing of the stock."

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* Although it might be argued that the impact of defendants' fraud upon Defiance stockholders located in New York would lead New York courts, as a matter of policy, to refuse to apply Ohio law with respect to ratification of a self-dealing transaction, this Court holds that New York would follow Ohio law on this issue. See *Hausman* v. *Buckley*, 299 F.2d 696, 702 (2d Cir. 1962). In any even if New York law were applied, the stockholders' ratification would be ineffective, regardless of whether it was procured by fraud. *Continental Securities Co.* v. *Belmont*, 206 N. Y. 7 (1912).

Krock, an active member of the triumvirate, repeatedly discounted the report, stating that it "showed a grossly inflated value for the IIE stock," and that it contained "flaws." It was just such material "flaws" that rendered the proxy statement misleading.

For the same reasons even after appropriate weight is given to the submission of the material for the May 28, 1962 proxy statement to the SEC for review before circulation, such review does not serve to relieve defendants from their breach of fiduciary duty and their violations of §§ 10(b) and 14 of the Exchange Act of 1934. See *Dunn* v. *Decca Records, Inc.*, 120 F. Supp. 1 (S.D.N.Y. 1954). There is no indication that the SEC was aware, as were the defendants, of the inflation in the Nablico earnings figures used in the proxy solicitation material, and it is difficult to believe that if the SEC had in fact noted the reference, which is buried away at the tailend of an irrelevant section, to the recent arm's length sale of 10% of IIE's stock at $20.94 per share, it would have permitted the proxy material to be circulated without placing that vital information where it would be more likely to be noted by Defiance stockholders. We can only conclude that the SEC was misled and that it failed to note the burial of this vital information, which was not included in the initial draft submitted to it for clearance.

Demand by plaintiff that the Board of Directors of Defiance bring this action was not made. However, such a demand would have been futile because in October, 1962 when this action was brought Huffines, Muscat and Krock comprised three of the six-man Board of Directors and furthermore they and their associates owned more than a majority of the voting stock of Defiance. In view of this domination and control by Huffines, Muscat and Krock, plaintiff sufficiently complied with Rule 23(b), now Rule 23.1.

Accordingly, for all the reasons set forth herein, Defiance is entitled to judgment in the sum of $3,199,297. In view of the substantial profits reaped by defendants through their wrongdoing, interest is awarded at the rate of 6% per annum on $2,902,940 from July 15, 1962 when the Defiance-IIS exchange was consummated (first and third causes of action) and on $296,357 from September 6, 1961, when Griffith's shares were acquired (second cause of action). See *Rose* v. *Lisle*, 267 F. Supp. 395 (S.D.N.Y. 1967); *Hey* v. *Dunmar*, 98 Ohio App. 104, 97 N.E.2d 702 (1950). Plaintiff is also entitled to recover from Defiance expenses necessary to the prosecution of this action, including reasonable attorneys' fees.

The foregoing constitutes the Court's findings of fact and conclusions of law pursuant to Rule 52, F.R.C.P.

Settle Order.

U.S.D.J.

Dated: May 15, 1968.

APPENDIX A

§ 10(b). *Manipulative and deceptive devices*

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

§ 14(a). *Proxies*

"(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 781 of this title."

Rule 10b-5, 17 C.F.R. 240.10b-5

"*Employment of Manipulative and Deceptive Devices*

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of inter-

state commerce, or of the mails, or of any facility of any national securities exchange,

"(a) to employ any device, scheme, or artifice to defraud,

"(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Norte & Co. v. Huffines, et al.—62 Civ. 3390

ENDORSEMENT (TO OPINION #34780)

The references in the opinion of this Court, dated May 15, 1968, at pp. 2, 3 and 37, to the amount of Class B Voting Stock of Defiance owned by Muscat, Huffines, Krock and their associates prior to the acquisition of all the outstanding stock of IIE as "87%", resulting in their realizing a profit of approximately "$2,703,910", are corrected to read "77%" and "$2,304,610", respectively.

These inadvertent errors do not in any way change the Court's conclusions and the amount of its judgment, which remain unaffected.

So Ordered.

/s/ WALTER R. MANSFIELD,
U.S.D.J.

Dated: May 16, 1968.

APPENDIX D

Opinion of the District Court Denying Defendants' Motions for a New Trial or Rehearing on Newly Discovered Evidence.

[Opinion No. 34956]

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

62 Civ. 3390

[SAME TITLE]

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Opinion of the District Cort Dennying Motions for New Trial or Rehearing.

MANSFIELD, *D.J.*:

Following non-jury trial of this consolidated derivative stockholders' action in which Defiance Industries, Inc. ("Defiance" herein) was awarded damages in the sum of $3,199,297, plus interest, defendants Muscat and Huffines move for a new trial pursuant to Rules 52, 59 and 60, F.R.C.P., or, alternatively, for rehearing on the issue of damages on the ground of newly discovered evidence and that the damages awarded are excessive.

The damages awarded in favor of Defiance against the individual defendants Muscat and Huffines, directors of Defiance, resulted from two transactions that were authorized and participated in by them at Defiance's expense:

(1) *"The 1962 Exchange,"* i.e., the issuance by Defiance of 487,502 shares of its Class B Voting Stock in exchange for all the outstanding stock of Insurance and Industrial Enterprises, Inc. ("IIE" herein), 77% owned by Muscat, Huffines and their co-venturer, Edward Krock, pursuant to defendants' recommendation valuing the IIE stock at $70.51 per share; and

(2) *"The September 6, 1961 Transaction,"* i.e., acquisition of 10,507 shares of IIE stock (representing approximately 10% of its issued stock) by the triumvirate of Muscat, Huffines and Krock at a price of $20.94 per share, which they then caused Defiance to acquire as part of the aforementioned 1962 exchange at a value of $70.51 per share, realizing a profit of approximately $520,832.

Damages in the sum of $2,993,000 were awarded in favor of Defiance against defendants Muscat and Huffines on the ground that approval of the 1962 Exchange by Defiance

stockholders was secured by defendants through false and misleading proxy material in violation of §§ 10b and 14 of the Securities Exchange Act of 1934, 15 U.S.C.A. §§ 78j(b) and 78n. and SEC Rule 10b-5 issued thereunder, and also on the ground that it was a self-dealing transaction grossly unfair to Defiance in that it was required to pay an excess of $29.93 per share for approximately 100,000 shares of IIE. With respect to the September 6, 1961 Transaction, damages in the sum of $206,357 were awarded on the ground that defendants deprived Defiance of a corporate opportunity to purchase the IIE shares at the lower price and reaped a profit at the expense of Defiance.

Defendants' post-trial motions raise no substantial question with respect to the September 6, 1961 Transaction or their liability for any damages caused by the 1962 Exchange. With respect to the question of damages awarded on account of the 1962 Exchange, defendants do not now attack the valuation of IIE stock received by Defiance in the exchange,* an issue fully litigated at trial, where it was determined to be worth $40.58 per share rather than the $70.51 per share adopted by defendants, an excess of $29.93 per share for approximately 100,000 shares of IIE, or $2,993,000.

The gist of defendants' present contentions is that the loss suffered by Defiance on the exchange was less than $2,993,000, and may even be eliminated completely, because the stock issued by Defiance in payment for the IIE shares

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* Defendants suggest in passing that the valuation of IIE stock was erroneous because it was based on the price received in the subsequent sale of its principal subsidiary, National Bankers Life Insurance Co. ("Nablico" herein), and this price was abnormally depressed by the "market break" of May 1962. However, the "market break" cannot be considered to have distorted the valuation of Nablico or IIE because the market fully recovered by December 1962, two months before the sale of Nablico in February 1963.

was worth less than the $14.49 per share found by the Court so that, at the exchange ratio of 4⅞ Defiance shares per one IIE share, Defiance did not pay as much as $70.51 per IIE share.

The issue of damages was before the Court at trial and was fully litigated, and defendants do not suggest that there is any pertinent newly discovered evidence. Accordingly defendants' motion to reopen the case for the introduction of additional evidence is denied. Defendants rely primarily on material already in the record, such as market data in the pretrial order, and also raise questions of law in urging that the damages awarded are excessive.

Review of that record reveals that defendants' present contention to the effect that Defiance stock was over-valued is not only belated, but contrary to, and inconsistent with, the proof offered by the parties and the position taken by the defendants both at pretrial and trial. Until the Court's decision the $14.49 price was accepted by them as a fair and reasonable figure resulting from an appraisal (Ex. 13 in evidence) made by well-recognized independent experts retained by the defendants themselves to evaluate Defiance's stock for the purpose of determining how many shares would be required to acquire IIE, which was valued at $7,050,759. At no point prior to the present post-decision motions did defendants question the value of $14.49 per Defiance share. Instead, defendants took the position that the study and report made at defendants' request by Hayden Stone & Co., a well known firm of highly regarded experts specializing in independent appraisal of corporate holdings which evaluated Defiance as having a fair value of $14.49 per share, was entitled to great weight in determining the relative values and ratios to be assigned to the stocks of the companies involved. Referreing to the retention of Hayden Stone, Muscat testified:

Opinion of the District Court Denying Motions for New Trial or Rehearing.

"Q. Who, on behalf of the company, that is, Defiance, negotiated with whom on behalf of the stockholders of I. and I. E.? A. The way the whole transaction was set up was that we wanted strictly impartial people to make the report, and to set it up, so the only discussion, actually, was after the Hayden Stone report.

Q. As you said before, the exchange ratio was made on the basis of the Hayden Stone report? A. Right." (Muscat Dep. pp. 43-44)

"Q. . . . Do you know of any reason why Hayden Stone didn't use the figures I have just read to you from Exhibit 2 for identification at Pages 4 and 5? A. Mr. Paulson, I am sure you know that we picked the best accountants, the best legal people, and the best investment houses to make these full studies. And each one may have their own interpretation. But I can assure you that they are the ones that put these figures together. I have not gone into the details at all, because if I could do it, I wouldn't need Peat Marwick, or Hayden Stone or anybody else.

So whatever they put down, I am sure is the way the S. E. C. wanted that report. I am sure on this report Hayden Stone was presenting the good sides, the bad sides. They may have their own interpretation.

All I can do is go to the best people in the country and ask them to help us out." (Muscat Dep. pp. 61-62)

In its opinion the Court found that the value of $14.49 per Defiance share recommended by Hayden Stone was sound, but concluded that Hayden Stone had erred in its evaluation of IIE for the reason that it had been misled by

certain inflated earnings figures furnished to it by the defendants for IIE's principal subsidiary, Nablico, all of which is more fully detailed in the Court's earlier opinion.

The methods used by Hayden Stone in the study leading to this report are well recognized and have been repeatedly accepted by the courts. The report states (P. Ex. 13, p. 1) that the appraisals of Defiance and IIE "attempt to take into account all relevant factors, including asset values, earning power, and past performances as well as future potentials. Due to the substantially different natures of the companies concerned, the approach for each is by necessity different in certain aspects."*

After careful review of all of the principal factors affecting the value of Defiance's stock, Hayden Stone, stating that its appraisal was for the purpose of determining the value of Defiance shares that might be issued in connection with a proposed merger, concluded that "the common equity of the Serrick Coporation [Defiance] is appraised at a fair value of . . . $14.49 per Class B share" (P. Ex. 13, p. 22). Thus, in order to acquire assets found to be worth between

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* The approach was thus similar to that described by the court in *Diston* v. *Loucks*, 62 N.Y.S. 2d 138, 144 (Sup. Ct. N. Y. Co. 1941), affd., 264 App. Div. 758, 35 N.Y.S. 2d 715, leave to appeal to Court of Appeals denied, 264 App. Div. 838, 35 N.Y.S. 2d 763 (1st Dept. 1942):

> "Many factors must be considered in determining true value, and earning power and ability to pay dividends are not the least of those factors. Thus there must be considered the record of the corporation and its prospects for the future, the investment value as determined by the rate of return, the selling price of stocks of like character, the appraised and sale value of assets, the market conditions, and any other relevant evidentiary facts and circumstances relating to the property which may reflect themselves in the worth of the stock." (62 N.Y.S. 2d at 144)

$6,751,686 and $7,350,338 Defiance would be required to issue almost 500,000 shares of Class B common stock.

Accepting this evaluation of Defiance stock by independent experts as fair and reasonable, the defendants used it as the basis for their recommendation to Defiance stockholders "that the proposed ratio of exchange is a fair one" (Proxy Statement, P. Ex. 1, p. 10), and relied upon it throughout the trial. Now for the first time they seek to impeach the evaluation, arguing that Hayden Stone improperly considered book value, liquidation value and replacement value. This argument is without merit. Valuation of Defiance by the capitalization of earnings approach was inappropriate because of significant recent losses. Furthermore, although Hayden Stone took into account the current market value of Defiance shares, which had been recently traded on the American Stock Exchange at $13 per share, it refused to accept such market price as equivalent to "fair value," and properly so because of the light trading in the stock; for example, of 220,000 shares outstanding, only 2,600 shares were traded in June, 1961. Market price is significant only

> "where there is a free and open market and the volume of transactions and conditions make the market a fair reflection of the judgment of the buying and selling public." *Application of Marcus;* 273 App. Div. 725, 727, 79 N.Y.S. 2d 76, 78 (1st Dept. 1948), app. dism., 277 App. Div. 963, 99 N.Y.S. 2d 849 (1st Dept. 1950), affd., 303 N. Y. 711 (1951).

The thinness of the market in Defiance stock was recognized by the defendants as rendering current market prices inappropriate for evaluation purposes. The defendant Huffines testified ". . . it was a very thin market, very little

trading" (Huffines Dep. p. 35), and Muscat testified that although the stock of Defiance was listed on the American Stock Exchange, in June of 1962 it "had a very, very thin market" (Muscat Dep. p. 70).

Giving consideration to market value, but recognizing its weakness as the sole measure of the value of Defiance, Hayden Stone stated:

> "The principal approach in appraising [Defiance] is from the point of view of asset values, namely the relationship between the book value of the company and the replacement and liquidating values of its capital assets. These values are compared with the market value of the company's stock. Because of the downward trend of earnings in recent years and the substantial deficits reported for fiscal 1960 and the nine month interim period to March 31, 1961, no meaningful appraisal may be obtained on the basis of earnings or average earnings over a 5 or 10 year period." (P. Ex. 13, p. 5)

Turning then to asset value, the principal alternative to the capitalization of earnings approach, Hayden Stone concluded that the stated book value of $14.49 per share in this instance also represented fair value. In arriving at this conclusion, Hayden Stone took into account that the stated book value tended to understate fair value because of liberal depreciation reserves. The well-depreciated figure at which assets were carried on the books was illustrated by reference to the sale of certain machinery at Defiance's Muncie, Indiana plant which resulted in a profit of $172,000 over a book value of $65,496. Hayden Stone also considered replacement value, but did not place much reliance on it, not calculating a firm total figure for replacement value. Ob-

serving that "In arriving at what is considered a fair value for [Defiance] it is necessary to balance the various factors discussed above" (i.e., book value, replacement cost, recent market price, and possible future plans of management), Hayden Stone concluded:

> "Taking into consideration the past record of the company, the steps new management is taking to restore operations to a profitable basis, and the generally liberal depreciation reserves, we believe the stated book value . . . represents a fair value for the corporation. . . . We do not feel the company can at present be valued fairly at a higher figure because of the lack of demonstrated earning power of the capital assets. To value [Defiance] at a lower figure would be equally inequitable in view of the well-depreciated figure at which the assets of the company are carried on its books."

Defendants' attack on the Hayden Stone report as erroneously relying on book value is, therefore, without foundation. The report considered the liberal depreciation reserves and, weighing the results of this asset valuation approach along with the earnings records, particularly the recent losses, concluded that fair value was $14.49 per share. Throughout the trial defendants accepted as authoritative the Hayden Stone report, including its valuation of the stock to be issued by Defiance at $14.49 per share and although they were given ample opportunity to challenge it or to offer any evidence tending to show a lower value for the Defiance stock, they chose not to do so. The report therefore constitutes probative and convincing evidence, particularly since it represents the results of an independent appraisal by recognized experts in the evalu-

ation of corporate properties, who were eminently well qualified. Repeatedly the defendants pointed to the fairness of the report, Muscat going so far as to testify that the effect of the report was to render the Defiance transaction an arm's-length one."

Accordingly the Court found that the fair value of the 487,302 shares of Defiance Class B Voting stock issued in exchange for the outstanding stock of IIE was $14.49 per share, and that finding is adhered to now.

Defendants next argue for the first time that even if Hayden Stone correctly valued Defiance stock at $14.49 per share, its report was issued in June 1961 and conditions had changed by the time the exchange was consummated a year later. More specifically they point to the fact that while the market price of Defiance stock in June 1961 was about $[illegible] per share, the price on June 20, 1962 (when the stockholder meeting approving the exchange was held) had declined to about $[illegible] per share. However, while market price is properly considered as one of the factors in arriving at a value for Defiance stock, it is neither controlling nor conclusive. Hayden Stone found the Defiance stock to be worth $[illegible] per share although its recent market price had been $[illegible] per share. The lack of significant trading in Defiance stock in June 1962, volume being only 2,800 shares for the month (see Appendix A), undercuts the significance to be attached to the market data for that month.

Neither Hayden Stone nor the defendants (at least until this Court rendered its decision) believed that changes in

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a "Q. The transaction where Defiance acquired the 100 per cent of the stock of I. and I. S. was an arm's-length transaction? A. Uh huh.

Q. You mean it was arm's-length because Hayden Stone was involved? A. That's exactly what I mean." (Muscat Dep. p. 68)

stock market conditions occurring in June 1962 required a re-evaluation of the Defiance shares to be issued for IIE's stock. On this subject Huffines testified:

> "Q. The covering letter submitting this Hayden Stone report was dated June 30, 1961; is that correct? A. Yes.
>
> Q. And the acquisition was not voted on by the stockholders until June of 1962, about a year later.
>
> Do you know whether or not in that interim of a year, the Hayden Stone report was brought up to date? A. Well, I know that they had information on the companies, in that interim period.
>
> Q. Did they submit any further report? A. I do not think so.
>
> My belief is they did not find it necessary or advisable to change anything in the report; but they did have operating figures on the company in the period."* (Huffines Dep. p. 57)

Furthermore, defendants place undue emphasis on the market price of about $8 per share for June 20, 1962. That market price cannot be considered out of the context of market data over the period of time surrounding that date. The market prices for Defiance stock from January to July 1962, as listed in the pretrial order, are as follows:

1962					
Jan.	9	11⅜	April	11	12¼
	19	11¾		13	12¾
	23	11½		19	11½
	30	11½		27	12

* These figures indicate an improvement in Defiance's earnings to the point of a profit of approximately $150,000 for the last six months of 1961 (P. Ex. 1, p. 13).

Feb.	2	11¼	May	1	11¾
	9	12⅜		28	11
	16	13	June	7	9⅝
	23	13½		15	7¾
Mar.	2	13½		22	8
	9	13½	July	6	8
	19	13½		12	9
	27	12¾		20	8¼
				27	7

Thereafter, the market price rose slightly to a high of 8½ in early September 1962 and then declined further.

This data reveals that from January until May 28, 1962 the market price of Defiance stock remained in the vicinity of the $13 per share, the same price taken into account by Hayden Stone in valuing the stock at $14.49 per share. That the market price thereafter dropped was, as defendants admit, in part the result of extraordinary market conditions namely, the "market break" of May 1962, from which general market prices did not recover until about December 1962. As market price is a reliable indicator of value only where "conditions make the market a fair reflection of the judgment of the buying and selling public," *Application of Marcus, supra,* the sharp drop in the market price of Defiance stock for the month of June as a result of abnormal market conditions cannot be considered significant in valuing Defiance.

Furthermore, the depressed price of the Defiance stock in June 1962 may also have been in part the result of the public announcement in the proxy statement of May 28, 1962 of the forthcoming exchange with IIE at a grossly excessive price. Defendants argue that the finding by the Court that the proxy statement was misleading would tend to "puff" the value of the Defiance stock rather than depress it. However

a few sophisticated professional traders (as distinguished from the average investor) would recognize that the ratio of exchange with IIE was grossly unfair to Defiance; and a market as thin as that prevailing at the time would be made by just such sophisticated professionals. Defendants can hardly take advantage of a fall in market price caused by their own breach of fiduciary obligation in recommending a ratio so detrimental to Defiance by arguing that that drop in price is to be taken into account in mitigation of the damages to Defiance.

Discounting the probative value of the market performance of Defiance stock for the period following May 28, 1962 because of the distortions introduced by the public announcement of the exchange and also the temporary "market break" which occurred about that time, it appears that from about January to May 1962 the market price of Defiance stock was in the vicinity of, but averaged slightly below, the $13 per share which Hayden Stone took into account in valuing the stock at $14.49 per share as of June 1961. However, against this slight decrease in market price must be weighed the increase in Defiance's earnings after June 1961, which improved to the point of a profit of approximately $150,000 for the last six months of 1961 (P. Ex. 1, p. 13).

Furthermore, prior to this Court's decision the defendants themselves did not consider the market price of Defiance's stock on June 20, 1962 to reflect its fair and true value. It is significant, for instance, that in the pretrial order the defendants, rather than select the June 20, 1962 market price as the indicator of market value to be used in describing the exchange, chose the bid and asked prices of Defiance stock on the American Stock Exchange on May 8, 1962, resulting in a value of $11.625 per share (Stip. of Facts

No. 19, Pretrial Order filed June 13, 1966). In addition the defendants repeatedly testified that the market price of Defiance stock did not reflect its true or fair value, not only because of the thinness of trading in the stock but also for the reason that a premium of at least 25% must be added for control. Although defendants, as the owners of approx[illegible]y 33⅓% of Defiance's issued stock before acquisition of IIE's stock, had working control of Defiance, the proposal under consideration was the issuance of 487,502 shares of Defiance stock which, being more than 50% of its issued stock, would constitute actual control of Defiance, supplanting their prior working control. In describing the additional shares to be issued, Muscat stated in an affidavit filed June 26, 1964:

> "23. The stock in Serrick owned by the interested directors at the time of the transaction was 'control' stock. Consequently, the additional shares received* were also 'control' stock, the market value of which cannot be measured by the price on the American Stock Exchange. 'Control' stock has, by definition, no market. There are strict limits on its marketability. Thus, its market value cannot be measured by reference to the American Stock Exchange price quotations."

Both Huffines and Muscat testified that a premium of 25% over market price for control stock was low in the case of industrials such as Defiance (Muscat Dep. p. 66; Huffines Dep. p. 73). But even the addition of only a 25% premium to the $11.625 per share market price stipulated by defendants as the basis for valuing the 487,502 Defiance shares would result in a value of $14.53 per Defiance share as com-

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* Referring to the 487,502 shares issued in exchange for IIE.

pared with $14.49 found by Hayden Stone to be a fair figure.*

On balance, the Court therefore concludes that its valuation of Defiance stock at $14.49 per share at the time of the exchange was not rendered excessive as a result of the market break following May 28, 1962, but represented a conservative estimate of its fair value.

Defendants further contend that the valuation of Defiance stock at $14.49 per share may not be used as a basis for assessing the damages suffered by it in paying an excessive price for the IIE stock because the valuation of Defiance stock is based on book value and the valuation of IIE is based principally on the market value of its principal subsidiary, Nablico. Defendants argue that a comparison using two such different standards, like a comparison of "apples" and "pears," is impermissible, and urge that the valuation of Defiance be made on a "comparable" basis by using the market price of its stock. However, the compelling reasons for the inappropriateness of the market price of Defiance stock as a yardstick have already been noted. Apparently recognizing these reasons, defendants argue in the alternative that the market price of about $11 per share at which Defiance stock was selling in early May, before the "market break" and public announcement of the exchange, be used as a basis for determining the amount of the excess which Defiance paid for the IIE shares.** The fact remains, however, that trading in the stock was so relatively light that mar-

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* It is well-recognized that a controlling block of stock has greater sale value than a small lot. See *Perlman* v. *Feldmann*, 219 F. 2d 173 (2d Cir.), *cert. denied*, 349 U. S. 952 (1955).

** As already noted, addition of a 25% premium for control value would increase the $11 price to approximately the $14.49 value adopted by the Court.

ket price cannot be considered the sole indicator of fair value.*

Furthermore, defendants' "apples and pears" argument is unjustified, at least under the circumstances of this case. The valuation of IIE primarily on the basis of the selling price received for its principal subsidiary, Nablico, in an arm's-length transaction, does not lead to the conclusion that the market price of Defiance stock should be the sole measure of value in any comparison with IIE. Neither the price paid for stock of IIE nor the market price of the stock of Nablico were the exclusive, or even the primary, basis for the valuation of IIE; and neither the Court nor Hayden Stone limited themselves to comparing the "liquidation" value of Defiance with the "market" value of IIE, as defendants charge. No one measure of value, such as book value, liquidation value, or replacement value, was exclusively used. The respective values of the stock of Defiance and IIE each were calculated on the basis of a variety of factors, which included earning power, adjusted book value, liquidation value, replacement value, and the selling price of stocks. The result of this process of valuation was the determination of fair value for Defiance stock of $14.49 per share and a fair value for IIE stock of $40.58 per share. Thus it was not error, in comparing the fair value of the stocks being exchanged, to find that 4⅞ shares of Defiance stock worth $70.51 were issued in exchange for one share of IIE stock worth $40.58 per share, an excess of $29.93 per IIE share, and a total excess of $2,993,000 for 100,000 IIE shares.

Defendants further contend that the damages are excessive for the reason that the award of approximately $3 mil-

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* From May 1 to 27, 1962, the only trading was 100 shares on May 1, so that market prices to which defendants refer are merely bid and asked prices. See Appendix A.

lion is roughly equal to the net worth of Defiance as of 1962, and argue that "It is hard to conceive how a corporation valued at slightly over $3 million could have lost $3 million and still remain intact." However, the evaluation of Defiance as worth $14.49 per share for purposes of acquiring IIE leads to the conclusion that Defiance had the capacity to acquire additional assets worth more than $7 million for almost 500,000 additional shares to be issued by it, which would thereby increase its net worth to over $10 million. Instead of acquiring assets worth the value of the additional shares, Defiance received assets worth only $4,057,759 or $2,993,000 less than the value of the shares. Defendants' suggestion that Defiance suffered no damage as a result of the issuance of almost 500,000 additional shares in exchange for over-valued consideration is without merit. See *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 203 (5th Cir. 1950), *cert. denied*, 365 U. S. 814 (1960); *Simon* v. *New Haven Board and Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966).

As an alternative to their argument that the excessive price paid by Defiance was less than the $2,993,000 awarded because the stock issued by Defiance was worth less than the $14.49 per share found by the Court, defendants argue that the damages to Defiance should be calculated on a theory other than the loss suffered by Defiance in the exchange. First, they suggest that the amount of profit made by defendants on the exchange is the appropriate measure of recovery due to Defiance. Although recovery of profits may be awarded where one who breaches a fiduciary obligation makes profits in excess of the loss caused by the breach, see *Jackson* v. *Smith*, 254 U. S. 586 (1921), one who breaches a fiduciary obligation is responsible for the entire loss suffered by the corporation as a result of the breach. This

liability is not limited to the recovery of profits or to "out-of-pocket" loss, i.e., the value of the stock which Defiance issued as a result of defendants' fraud less the value of IIE stock received, but is measured under the "loss of the bargain" rule by the difference between the value of what Defiance would have received if defendants' false and misleading representations based on an evaluation of the IIE stock as worth $70.51 per share were true,* and the value of what it actually did receive. See McCormack on Damages § 121 (1035 ed.); *Gray* v. *Gordon,* 96 Ohio St. 490, 117 N. E. 891 (1917); *Henschel* v. *Schreiber,* 72 N. E. 2d 107 (Ohio Ct. App. 1946).

Second, defendants suggest that damages should be awarded not to Defiance but to the individual stockholders of Defiance, other than Huffines, Muscat, Krock and their associates, who held their Defiance stock immediately prior to the 1962 Exchange. Defendants argue that only these stockholders suffered actual damage by dilution of the value of their holdings. However, this is a derivative action brought on behalf of Defiance in which recovery was awarded to Defiance for damages suffered by it as a result of its paying an excessive price for IIE and being deprived of the opportunity to purchase IIE at $20.94 per share. The general rule in a derivative action is that recovery is awarded to the corporation on behalf of which suit is brought, and that the corporation may not be "by-passed" by an award to individual stockholders on a pro rata basis, which would, in effect, declare a dividend of the corporate recovery. See *Liken* v. *Shaffer,* 64 F. Supp. 432 (N. D. Iowa 1946, per Graven, J.); *Keenan* v. *Eshleman,* 23 Del. 234, 2

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* The same misinformation which led Hayden Stone to recommend the $70.51 figure could reasonably be expected to lead a Defiance stockholder to the same result.

A. 2d 904, 912-13 (1938); 13 Fletcher Cyclopedia of Corporations (1961) 641-47 § 6028.

This case does not fall within the exceptions to this rule which have occasionally been made to avoid unnecessary litigation, such as when a corporation is in process of liquidation, see *Bowker* v. *Nashua Textile Co.*, 103 N. H. 242, 169 A. 2d 630 (1961), and in other unusual circumstances, see *Perlman* v. *Feldmann*, 219 F. 2d 173 (2d Cir.) *cert. denied*, 349 U. S. 952 (1955) (pro rata recovery awarded to remedy the sale of corporate control for excessive consideration); *May* v. *Midwest Ref. Co.*, 121 F. 2d 431 (1st Cir.), *cert. denied*, 314 U. S. 668 (1941) (dismissal of a derivative suit sustained upon the offer by defendant, who owned 99.96% of the stocks, to pay the plaintiff-shareholder the maximum amount that his share interest could have been depreciated by any wrongful dealings); *DiTomasso* v. *Loverro*, 250 App. Div. 206, 293 N. Y. Supp. 912 (2d Dept.), *aff'd.*, 276 N. Y. 551 (1937) (pro rata recovery awarded to plaintiff who brought a derivative action on behalf of a closely held corporation against defendants, who included all the other stockholders but one). Furthermore, that certain of the present stockholders of Defiance may not have been stockholders at the time of the transactions complained of is no ground for diminishing the damages awarded to the corporation. *Overfield* v. *Pennroad*, 48 F. Supp. 1008, 1018 (E. D. Pa. 1943), *rev'd in part on other grounds*, 146 F. 2d 889 (3d Cir. 1944); cf. *Central Ry. Signal Co.* v. *Longden*, 194 F. 2d 310 (7th Cir. 1952). They are not unjustly enriched by the award to the corporation because at the time of purchase they acquired a proportionate indivisible interest in the claims asserted in this action on its behalf, see *Pollitz* v. *Gould*, 202 N. Y. 11, 15 (1911). Finally, there is no suggestion that a pro rata award is required because a corporate recovery would

be dissipated by the management, see *Backus* v. *Finkelstein,* 23 F. 2d 357 (D. Minn. 1927). Accordingly, since none of the special circumstances in which pro rata recovery has been awarded exist here, the theory of the derivative action must be recognized and recovery awarded to the corporation.

Finally, defendant Huffines urges that the award of prejudgment interest should be vacated on the grounds that the award is not required to compensate Defiance for loss of money or its equivalent and that Huffines did not realize substantial profits by his wrongdoing. The award of interest on unliquidated claims is a matter within the discretion of the Court both with respect to the federal claims under §§ 10 and 14 of the Securities and Exchange Act of 1934, see *Ross* v. *Licht,* 263 F. Supp. 395 (S.D.N.Y. 1967), and with respect to the claims under state law for breach of fiduciary obligation, see *Hey* v. *Cummer,* 89 Ohio App. 104, 97 N. E. 2d 702 (1950) (interest awarded on secret profits gained by agent at his principal's expense).

Huffines argues that the award of interest in this case is improper on the grounds (1) that Huffines did not in fact realize a profit on the Defiance shares issued to him, since in 1966 82,809 shares were sold at $8 per share and 16,500 shares at prices ranging from $10.80 per share to $12.55 per share; and (2) that there is no showing that Defiance would have realized an economic benefit from the excess shares issued as a result of the over-valuation of IIE.

The basic principle governing the exercise of the Court's discretion in deciding whether to award prejudgment interest is the fundamental consideration of fairness rather than measurement of the value of the use to which property or money might have been put by the plaintiff if it had not been deprived thereof by the defendants' wrongful conduct.

Opinion of the District Court Denying Motions for New Trial or Rehearing.

> "[I]nterest is not recovered according to a rigid theory of compensation for money withheld, but is given in response to considerations of fairness." *Board of Comm'rs.* v. *United States,* 208 U. S. 343, 352 (1939).

With respect to the September 6, 1961 Transaction the defendants wrongfully deprived Defiance of the opportunity to buy shares at $20.94 per share instead of the much higher price paid through issuance of Defiance stock, thereby realizing a profit of $206,357 after adjustment for damages awarded against them with respect to the 1962 Exchange. The loss to Defiance was clear and immediate, and the defendants' wrong was flagrant. In view of the contemporaneous September, 1961 resolution of Defiance's Board recommending the acquisition of the IIE shares, and the fact that the shares were soon thereafter acquired by Defiance from the defendants at the higher price, there can be little question about the fact that if the opportunity to buy the shares had been offered to it at $20.94 per share, Defiance would have taken advantage of that opportunity. Under such circumstances, imposition of prejudgment interest on the profit of $206,357 is fully justified.

With respect to the 1962 Exchange, the fact that Huffines did not in fact realize a profit on this sale of Defiance shares acquired by him is not persuasive. 82,809 of these shares were sold in 1966 to a nominee for a group consisting of Muscat and Messrs. Roy Cohn, Thomas A. Bolan and William P. Ruffa. In 1966 the present action on Defiance's behalf was pending, so that if Huffines had chosen to retain his Defiance shares, an award of damages in Defiance's favor would have resulted in an increase in the proportionate share of the corporation's equity attributable to the Defiance stock owned by him. The fact

that Hughes decided to sell most of his shares instead of awaiting the outcome of this suit was his business and his risk. As it is he apparently sought to protect himself by obtaining an indemnity from Masser, the value of which must be added to the [illegible] sales price. Furthermore, if hindsight, including [illegible] events, is to be used—and it is extremely questionable whether it should be—defendants cannot select certain facts and ignore others. Records of trading on the American Stock Exchange, see Appendix B, reveal that in 1962 Defiance Class B common stock reached a high of $[illegible] per share in March, $17¼ per share in April, $18¾ per share in May, $15 per share in June, $[illegible] per share in July, and $[illegible] per share in August; and that the volume of trading, unlike the total of 6,300 shares during April-June, 1962, inclusive, see Appendix A, was as follows: March, 24,000 shares; April, 244,100 shares; May, [illegible] shares; June, 93,100 shares; July, [illegible] shares; and August, 31,500 shares. If allowance were made for the stock dividends declared between June 1962 and 1968, which were 175%, the price of a Defiance Class B common share acquired in June 1962 would have gone even higher.

The defendants' suggestion that prejudgment interest should not be awarded in the absence of a showing that Defiance would have realized an economic benefit from the excess shares issued pursuant to the over-valuation of IIE must be dismissed as frivolous. *See Board of Comm'rs v. United States*, *supra*. The effect of the suggestion would be to ignore their egregious misfeasance in using false and misleading statements having the effect of over-valuing IIE, [illegible] which was known to them, for the purpose of wrongfully depriving [illegible] of [illegible] on the defendants' part. outstanding excess shares. This is not a case of innocent wrongdoing or even of negligence on the defendants' part.

Opinion of the District Court Denying Motions for New Trial or Rehearing.

It is a case of abuse of fiduciary duty carried out by the defendants with a view to profiting at the expense of those to whom the duty was owed and through use of materially false and misleading statements. As a direct result of their misconduct, Defiance issued more than 200,000 shares (worth $14.48 per share) over and above what it would have issued if the truth with respect to the value of IIE shares had been disclosed. There is no evidence supporting Huffines' suggestion that Defiance could not obtain property or money worth $2,993,000 in exchange for these excess shares, other than defendants' contention that current stock market prices of Defiance stock were substantially lower than $14.49 per share. The unreliability of such prices, in view of the extreme thinness of the market in Defiance stock and the fact that such lower prices may well have been attributable in part to defendants' own unconscionable conduct, does not entitle them to be relieved of prejudgment interest. Furthermore, Defiance's capacity to realize this amount is illustrated not only by the later increase in the market price of its stock (up to $17⅞ per share in 1966), but by its issuance of additional shares in recent years in exchange for acquisition of other properties. The fact remains that Defiance suffered $2,993,000 in damages as a result of the defendants' flagrant breach of trust.

Accordingly defendants' motions are denied in their entirety. Pursuant to Rule 52(b), F.R.C.P., the foregoing shall constitute additional findings of fact and conclusions supplementing those found in the Court's decision dated May 15, 1968. Judgment will be entered in favor of Defiance, with the plaintiff being authorized to take all steps necessary to issue execution on its behalf.

Settle Order.

WALTER R. MANSFIELD,
U.S.D.J.

Dated: June 27, 1968.

APPENDIX A

DEFIANCE INDUSTRIES, INC.

DAILY VOLUME OF TRADING ON THE AMERICAN STOCK EXCHANGE

April 1, 1962—June 30, 1962

Trading Date	Day of Week	Volume Sales in 100's	No Trading Only Bid & Asked Prices Shown	Monthly Total
April 2	M		X	
3	T	200	X	
4	W		X	
5	T		X	
6	F		X	
9	M		X	
10	T		X	
11	W	300		
12	T		X	
13	F	800		
16	M	100		
17	T	200		
18	W		X	
19	T	400		
20	F	Market Closed	—	Religious Holiday
23	M		X	
24	T		X	
25	W	500		
26	T		X	
27	F	100		
30	M		X	2,600
May 1	T	100		
2	W		X	
3	T		X	
4	F		X	

Opinion of the District Court Denying Motions for New Trial or Rehearing.

Trading Date	Day of Week	Volume Sales in 100's	No Trading Only Bid & Asked Prices Shown	Monthly Total
7	M		X	
8	T		X	
9	W		X	
10	T		X	
11	F		X	
14	M		X	
15	T		X	
16	W		X	
17	T		X	
18	F		X	
21	M		X	
22	T		X	
23	W		X	
24	T		X	
25	F		X	
28	M	100		
29	T	800		
30	W	Market Closed	—	Holiday
31	T	100		1,100
June 1	F		X	
4	M		X	
5	T		X	
6	W		X	
7	T	100		
8	F		X	
11	M	100		
12	T		X	
13	W	200		
14	T	100		
15	F	1,200		
18	M	300		
19	T		X	

Opinion of the District Court Denying Motions for New Trial or Rehearing.

Trading Date	Day of Week	Volume Sales in 100's	No Trading Only Bid & Asked Prices Shown	Monthly Total
20	W	100		
21	T	100		
22	F	600		
25	M		X	(Name changed to Defiance)
26	T		X	
27	W		X	
28	T		X	
29	F		X	2,800

(Source: Wall Street Journal)

APPENDIX E

Judgment of the District Court.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

62 Civ. 3390

#69,409

[SAME TITLE]

The above entitled consolidated action having come on for trial before the Court, Hon. Walter R. Mansfield, presiding, and the issues having been fully tried, and a decision having been duly rendered, and post-trial motions of defendants Huffines and Muscat having been denied and an order having been entered herein on July 2, 1968, directing that judgment be entered herein against the defendants, R. L. Huffines, Jr. and Victor Muscat, and severing the action against the defendants L. F. Serrick, Alfred O'Gara and Edward Krock, and determining that there is no just reason for delay in the entry of final judgment, and expressly directing the entry of said judgment, it is hereby

ORDERED, ADJUDGED AND DECREED that defendant, Defiance Industries, Inc. recover of the defendants R. L. Huffines, Jr. and Victor Muscat, $3,199,297 with interest at the rate of six (6%) per cent annum on $2,992,940 from July 13, 1962, which interest amounts to $1,071,842 and with interest at the rate of six (6%) per cent per annum on $206,357 from September 6, 1961, which interest amounts to $84,456 aggregating in all the sum of $4,355,595 and it is further

Judgment of the District Court

ORDERED, ADJUDGED AND DECREED that plaintiff Norte & Company have judgment against defendants, R. L. Huffines, Jr. and Victor Muscat, for its costs to be taxed by the Clerk, and it is further

ORDERED, ADJUDGED AND DECREED that this Court retain jurisdiction of this action for the purpose of passing upon any application which may be made for such further orders or directions as may be necessary or appropriate to carry out, enforce or satisfy the judgment and for the purpose of passing upon any application by plaintiff to recover from Defiance Industries, Inc. the expenses necessary to the prosecution of this action, including reasonable attorneys' fees.

Dated, New York, N. Y.
July 2, 1968

WALTER R. MANSFIELD

JUDGMENT ENTERED 7/2/68

JOHN J. OLEAR, JR.
Clerk

APPENDIX F

Stipulation.

UNITED STATES DISTRICT COURT,
SOUTHERN DISTRICT OF NEW YORK.

NORTE & CO.,

Plaintiff,

against

R. L. HUFFINES, JR., VICTOR MUSCAT, L. F. SERRICK, ALFRED O'GARA, EDWARD KROCK and DEFIANCE INDUSTRIES, INC.,

Defendants.

WHEREAS, on July 2, 1968, judgment in the above entitled action was entered in favor of Defiance Industries, Inc., against the defendants Victor Muscat ("Muscat") and R. L. Huffines, Jr. ("Huffines"), in the sum of $4,355,595, which judgment included interest at the rate of 6% per annum on $2,992,940 from July 13, 1962, amounting to $1,071,842, and interest at the rate of 6% per annum on $206,357 from September 6, 1961, which interest amounted to $84,456, aggregating in all the sum of $4,355,595; and

WHEREAS, Muscat and Huffines appealed from said judgment to the Circuit Court of Appeals for the Second Circuit; and

WHEREAS, on September 16, 1969, the said Circuit Court of Appeals unanimously affirmed said judgment; and

WHEREAS, Muscat and Huffines thereafter petitioned said Circuit Court of Appeals for a rehearing, and upon rehearing to reverse the aforesaid judgment insofar as it awards pre-judgment interest; and

WHEREAS, said Circuit Court of Appeals on October 14, 1969, granted said petitions of Muscat and Huffines for a

rehearing and remanded the matter to the District Court to reconsider the question of interest and otherwise unanimously affirmed in all respects the aforesaid judgment against Muscat and Huffines; and

WHEREAS, subject to the approval of the Court, the parties have agreed to reduce the rate of interest in the aforesaid judgment against Muscat and Huffines from 6% per annum to 3% per annum;

NOW, THEREFORE, SUBJECT TO THE APPROVAL OF THE COURT, IT IS HEREBY STIPULATED, CONSENTED AND AGREED AS FOLLOWS:

1. The interest awarded to Defiance Industries, Inc. by the aforesaid judgment at the rate of 6% per annum on $2,992,940 from July 13, 1962, amounting to $1,071,842, shall be computed for said period at the rate of 3% per annum, and as so computed amounts to $535,921. The interest awarded to Defiance Industries, Inc. by the aforesaid judgment at the rate of 6% per annum on $206,357 from September 6, 1961, amounting to $84,456, shall be computed for said period at the rate of 3% per annum, and as so computed amounts to $42,228.

2. Said judgment of July 2, 1968 against Muscat and Huffines be and the same hereby is reduced by the aggregate of the reduction in interest as specified in paragraph 1 hereof, and shall be deemed to be a judgment in favor of Defiance Industries, Inc. against Muscat and Huffines in the sum of $3,777,346 and shall stand as a judgment in that amount against Muscat and Huffines with the same force and effect as though judgment in said sum of $3,777,346 had been originally rendered and entered herein.

3. The judgment clerk is hereby directed to enter upon his judgment record that the aforesaid judgment of July 2, 1968 in favor of Defiance Industries, Inc. against Muscat

and Huffines in the sum of $4,355,595 is reduced to the sum of $3,777,346.

4. Except as said judgment has been reduced as aforesaid, said judgment and the rights and remedies of plaintiff and Defiance Industries, Inc. shall remain unaffected and unimpaired.

5. This stipulation is without prejudice to the right of Muscat and Huffines to petition the Supreme Court of the United States for certiorari to review said judgment as hereby reduced, and is without prejudice to any other rights or remedies that Muscat and Huffines may have with respect to said judgment.

6. It is further stipulated and agreed that if the said judgment is reversed, remanded, reduced or vacated with respect to the principal amounts of $2,992,940 and/or $206,357, the amounts of pre-judgment interest will similarly be vacated or calculated at 3% of the said principal amounts as reduced.

Dated: December 4, 1969.

MILTON PAULSON
Milton Paulson
Attorney for Plaintiff

Burke & Burke
BURKE & BURKE
By HAROLD WOLFRAM
Burke & Burke
Attorneys for Defendant
Defiance Industries, Inc.

GOLDSTEIN, GURFEIN, SHAMES & HYDE
Goldstein, Gurfein, Shames & Hyde
Attorneys for Defendant Muscat

ROYALL, KEOGEL & WELLS
ROYALL, KEOGEL & WELLS
Attorneys for Defendant Huffines

So ORDERED:
WALTER R. MANSFIELD
U. S. D. J.

APPENDIX G

Statutes and Regulations.

STATUTES

TITLE 15 U.S.C.

§ 78n. Proxies.

(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interestate commerce or any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or fo rthe protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 781 of this title.

(b) It shall be unlawful for any member of a national securities exchange, or any broker or dealer registered under this chapter in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to give, or to refrain from giving a proxy, consent, or authorization in respect of any security registered pursuant to section 781 of this title and carried for the account of a customer.

(c) Unless proxies, consents, or authorizations in respect of a security registered pursuant to section 781 of this title are solicited by or on behalf of the management of the issuer from the holders of record of such security in accordance with the rules and regulations prescribed under subsection (a) of this section, prior to any annual or other meeting of the holders of such security, such issuer shall, in accordance with rules and regulations prescribed by the Commission, file with the Commission and transmit

to all holders of record of such security information substantially equivalent to the information which would be required to be transmitted if a solicitation were made, but no information shall be required to be filed or transmitted pursuant to this subsection before July 1, 1964.

* * *

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purpose or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

REGULATIONS

TITLE 17 C.F.R.

§ 240.14a-9 FALSE OR MISLEADING STATEMENTS

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral,

containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

§ 240.10b-5 EMPLOYMENT OF MANIPULATIVE AND DECEPTIVE DEVICES.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commence, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

FEDERAL RULES OF CIVIL PROCEDURE

Rule 16. Pre-Trial Procedure; Formulating Issues

In any action, the court may in its discretion direct the attorneys for the parties to appear before it for a conference to consider

(1) The simplification of the issues;

(2) The necessity of desirability of amendments to the pleadings;

(3) The possibility of obtaining admissions of fact and of documents which will avoid unnecessary proof;

(4) The limitation of the number of expert witnesses;

(5) The advisability of a preliminary reference of issues to a master for findings to be used as evidence when the trial is to be by jury;

(6) Such other matters as may aid in the disposition of the action.

The court shall make an order which recites the action taken at the conference, the amendments allowed to the pleadings, and the agreements made by the parties as to any of the matters considered, and which limits the issues for trial to those not disposed of by admissions or agreements of counsel; and such order when entered controls the subsequent course of the action, unless modified at the trial to prevent manifest injustice. The court in its discretion may establish by rule a pre-trial calendar on which actions may be placed for consideration as above provided and may either confine the calendar to jury actions or to non-jury actions or extend it to all actions.

APPENDIX H

SUPREME COURT OF THE UNITED STATES,

No. ....., October Term, 1969.

VICTOR MUSCAT and R. L. HUFFINES, JR.,

Petitioners,

vs.

NORTE & CO.

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI

UPON CONSIDERATION of the application of counsel for petitioner(s),

IT IS ORDERED that the time for filing a petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including January 30th, 1970.

/s/ JOHN M. HARLAN,
Associate Justice of the Supreme
Court of the United States.

Dated this 13th day of December, 1969.

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SUPREME COURT, U. S.

FILED
FEB 26 1970

Supreme Court of the United States

OCTOBER TERM, 1969

1135

VICTOR MUSCAT AND R. L. HUFFINES, JR.,

Petitioners,

—against—

NORTE & CO.,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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of counsel

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Supreme Court of the United States

October Term, 1969

VICTOR MUSCAT AND R. L. HUFFINES, JR.,

Petitioners,

—against—

NORTE & Co.,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Opinion Below

Petitioners have omitted citation of the opinion of the District Court rendered after trial, which is 304 F. Supp. 1096.

Preliminary Statement

Petitioners seek a writ of certiorari to review a judgment of the United States Court of Appeals for the Second Circuit, unanimously affirming a judgment of the United States District Court for the Southern District of New York after a trial on the merits.

Petitioners pose five questions which they contend require review by this Court (Pet. pp. 2-3). None of the questions raised presents a proper basis for certiorari because it is demonstrable that either (1) the questions presented are not involved in this case and are, therefore, entirely hypothetical, or (2) they involve contested issues of fact decided against petitioners by the District Court and affirmed by the Court of Appeals.

Additional Rules Involved

In addition to the statutes and regulations set forth in the petition (A 72-76), the following rules are involved: Rule 19 of the Rules of the Supreme Court of the United States; and Rules 8(f) and 15(b) of the Federal Rules of Civil Procedure.

Statement of the Case

The action is a derivative stockholder's suit brought on behalf of Defiance Industries, Inc. ("Defiance") against its principal officers, directors and controlling stockholders. The amended complaint asserts three causes of action. The first, a common law cause of action, based on diversity of citizenship, alleges that petitioners, together with one Edward Krock (named as a defendant, but not served), caused Defiance to issue a grossly excessive number of its shares in exchange for shares of Insurance and Industrial Enterprises, Inc. ("IIE"), a corporation 77% owned by petitioners and Krock (R 6a-12a).*

Liability on the second cause of action was conceded by petitioners and is, therefore, not involved on this application.**

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* References designated by the letter "R" refer to petitioners' appendix on their appeal to the Court of Appeals.

** The second cause of action, likewise a common law claim based on diversity of citizenship, alleges that petitioners and Krock appropriated an opportunity belonging to Defiance to acquire 10% of the stock of IIE at $20.94 per share at the very time petitioners and Krock were conspiring to sell these shares to Defiance at $70.51 per share (R 12a-13a). Judgment in the sum of $206,357 was rendered against petitioners on this cause of action. On their appeal to the Court of Appeals, petitioners conceded that they had appropriated this corporate opportunity and that they should have tendered the shares in question to Defiance at their cost.

The third cause of action alleges that petitioners secured stockholder approval of the exchange transaction between Defiance and IIE on the basis of a false and misleading proxy statement in violation of §§ 10 and 14 of the Securities Exchange Act of 1934 ("Act") and the SEC rules adopted thereunder (R 14a-18a).

The District Court awarded judgment with respect to the first cause of action upon the ground that petitioners had violated "their state-law fiduciary obligation to Defiance (first cause of action) by causing it to acquire all of the stock of IIE, 77% owned by them and their associates, at an inflated price" (A 35).* In this connection the District Court further held (A 32):

> "Plaintiff has established a clear case of gross and deliberate fraud on the part of defendants Huffines and Muscat, knowingly participated in by Krock, in breach of their fiduciary duties to Defiance's stockholders and with the purpose and effect of profiting at the expense of its stockholders. It is difficult to conceive of more flagrant and callous breaches of trust on the part of corporate fiduciaries than those found here."

The District Court also awarded judgment with respect to the third cause of action upon the ground that the proxy statement, on the basis of which the Defiance-IIE exchange was approved by the shareholders of Defiance, was false and misleading in material respects (A 19-29). The District Court expressly held (A 34-36) that petitioners had personal knowledge of the false representations made in the proxy statement (A 34-35).

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* Reference designated by the letter "A" refer to petitioners' appendix annexed to their petition.

Petitioners thereafter moved for a new trial on the ground of alleged newly discovered evidence. On that motion petitioners contended for the first time that the Court, in assessing damages, should have accepted the market price of the stock of Defiance as its fair value, rather than the fair value of $14.49 per share fixed by Hayden Stone & Co., petitioners' own expert (A 44).

In rejecting that contention, the District Court held (A 44):

> "Review of that record reveals that defendants' present contention to the effect that Defiance stock was over-valued is not only belated, but contrary to, and inconsistent with, the proof offered by the parties and the position taken by the defendants both at pretrial and trial."

The District Court, notwithstanding its view that petitioners' contention that the market price of Defiance's stock should be equated to its fair value was belatedly made, nevertheless, carefully explored petitioners' contention and concluded that (A 50) "while market price is properly considered as one of the factors in arriving at a value for Defiance stock, it is neither controlling nor conclusive".* After considering all of the elements usually taken into account in arriving at fair value, the District Court held that "The result of this process of valuation was the determination of fair value of Defiance stock of $14.49 per share * * *". (A 56)

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* The District Court noted (A 63) "The unreliability of such prices, in view of the extreme thinness of the market in Defiance stock and the fact that such lower prices may well have been attributable in part to defendants' own unconscionable conduct. . . ."

Petitioners, on their motion for a new trial, also contended for the first time that the award of damages should have been made to the innocent shareholders of Defiance, rather than to Defiance, itself (A 58). The District Court rejected that contention, holding (A 58) that "The general rule in a derivative action is that recovery is awarded to the corporation on behalf of which suit is brought * * *."

In unanimously affirming the District Court, the Court of Appeals held that "A study of the record shows ample support of Judge Mansfield's findings * * *". (A 3) The Court of Appeals concurred with the District Court that petitioners had "acted in violation of their fiduciary duties as controlling officers and directors of Defiance" (A 3) and that their conduct was the result of "calculated fraud" (A 5). The Court of Appeals also agreed that an award of damages to Defiance was the appropriate form of relief (A 4).

Petitioners thereafter moved for a rehearing limited to the question of prejudgment interest. The Court of Appeals remanded the matter to the District Court "for further consideration of prejudgment interest" (A 7) but "affirmed in all other respects" (A 8) the judgment of the District Court.

The Court of Appeals directed the District Court to give further consideration to whether the prejudgment interest awarded was "compensatory" and "in accord with 'fundamental fairness' ".* (A 7) In that connection, the Court of Appeals, among other things, directed the District Court to "make specific findings, first, on the personal wrongdoings of Huffines and Muscat". (A 7) Clearly, the Court's

* The issue of prejudgment interest was settled by stipulation, approved by the District Court (A 69-71).

direction did not, and was not intended to, as petitioners imply (Pet. fn. p. 12), negate its prior finding that petitioners were guilty of "calculated fraud". (A 5)

Summary of the Argument

None of the questions raised by petitioners present any basis for certiorari.

The first four questions posed by petitioners for review by this Court do not arise out of the facts of the case and are, therefore, entirely hypothetical. It is well settled that this Court will not render advisory opinions by reviewing issues which are not presented by the facts of the case before it.

The fifth question posed by petitioners involves an issue of fact decided against the petitioners by the District Court and unanimously affirmed by the Court of Appeals. It is equally well settled that this Court will not review concurrent findings of fact by two lower courts. Furthermore, since the judgment is also based on common law diversity grounds, any decision by this Court on federal grounds would not disturb the judgment.

1. *The First Question:* Petitioners contend (Pet. p. 18) that in awarding judgment in favor of Defiance, rather than to its innocent stockholders, the courts below were "strait-jacketed" by state law and further contend (Pet. pp. 21-22) that there is a conflict among the Circuit Courts of Appeal over whether, in a diversity case, federal courts are bound to apply state court remedies. These questions, advanced for the first time on this application for a writ of certiorari, do not arise from the actual facts of this case.

Neither the District Court nor the Court of Appeals in awarding judgment to Defiance, rather than to its share-

holders, was constrained to do so by any requirement of state law. Neither court made any reference to state law relating to the appropriate remedy, or to any possible conflict which might exist among the Circuit Courts of Appeal on this question. Both courts, *in the exercise of their discretion,* in awarding judgment in favor of Defiance, followed the traditional and generally accepted equitable principle that in a derivative suit the award of damages goes to the wronged corporation, not to its shareholders.* Accordingly, since the question of state law *versus* federal law, ie., the application of the doctrine of *Erie R. Co.* v. *Tompkins,* 304 U.S. 64 (1938), was neither raised nor involved in the case, the question of a conflict among the Courts of Appeal on the question was likewise never an issue in the case. It may not, therefore, be raised now. (*Stern & Gressman,* Sup. Ct. Practice, 4th ed. (1969) § 6.37 at p. 297)

The real complaint of petitioners is not based, as they contend (Pet. p. 20), on any alleged erroneous application of the *Erie* doctrine, or any conflict among the circuits, but rather, that the courts below refused to exercise discretion in petitioners' favor and awarded judgment in favor of Defiance, itself. This Court does not review the exercise of discretion by lower courts in the absence of a showing of a clear abuse. (*Moor* v. *Texas & New Orleans R. Co.,* 297 U.S. 101, 105, 80 L Ed 509, 511 (1935))

2. *The Second Question:* Petitioners contend (Pet. p. 12) that the courts below, in fixing the fair value of Defiance at $14.49 per share, ignored a stipulation in the pre-trial order that the shares had a market value of $11.625 per

* It would have been superfluous for the courts below to have distinguished between the applicability of state or federal law, since the judgment was based on a violation of *both* state and federal law.

share. The District Court, however, did not ignore the stipulation.

On the contrary, the District Court accepted the stipulated market price of Defiance's shares as the fact (A 53), but held that "it is neither controlling nor conclusive" (A 50) on the issue of the fair value of Defiance's shares. In view of the "thin" market prevailing, the Court accepted the report of Hayden Stone & Co., petitioners' own expert, that the fair value of Defiance's shares was $14.49 per share (A 44, 46-48, 54-55).

The stipulation in the pre-trial order as to "market value" was never intended to foreclose inquiry into the "fair value" of Defiance's shares. By the terms of the pre-trial order, that issue was reserved for the trial (R 147a, 148a). Indeed, throughout the trial, both sides accepted Hayden Stone's evaluation of Defiance at $14.49 per share, and the entire case was tried on that theory (A 44).

Accordingly, petitioners' contention that the courts below ignored the pre-trial stipulation does not accord with the undisputed facts.

3. *The Third and Fourth Questions:* Petitioners contend (Pet. pp. 12-14) (a) that this Court should review the question of whether *scienter* must be proved to recover damages for violations of §§ 10 and 14 of the Act and Rule 10b-5 and 14a-9; and (b) the extent to which reliance on the "clearance" by the SEC of a proxy statement negates fraud. Neither of these issues arises out of the facts of this case.

The District Court expressly found that petitioners had *knowingly* misrepresented material facts in the proxy statement and that they had "misled" the SEC by withholding this information from it (A 34-35, 37). The Court of Appeals

unanimously affirmed. Accordingly, the issues thus raised by petitioners are academic in this case and ought not be reviewed by this Court.

4. *The Fifth Question:* Petitioners contend (Pet. p. 3) that this Court should review the fairness of the Defiance-IIE exchange transaction. The fairness of the exchange was the principal issue upon the trial. On that issue of fact, the District Court held that the ratio of exchange was grossly unfair to Defiance, and the Court of Appeals unanimously affirmed. This Court will not review an issue of fact determined by the District Court and unanimously concurred in by the Court of Appeals. (*Berenyi* v. *Immigration Service,* 385 U.S. 630, 635, 17 L Ed 2d 656, 661 (1966).

Finally, it may be observed that review by this Court of the federal questions which petitioners purport to raise (Questions "2", "3" and "4") cannot affect the judgment in this case. This is so because the judgment here is based on common law diversity claims (as well as on federal claims). The judgment against petitioners for breach of their common law fiduciary duties would be unaffected, even assuming this Court believed that the courts below had erroneously construed, or applied, federal law.

POINT I

The petition should be denied because the questions posed by petitioners do not arise out of the facts in the case or they involve issues of fact.

This Court has consistently held that it will not grant certiorari to review hypothetical questions which are not presented by the facts of the particular case before it. As this Court stated in *Conway* v. *Adult Authority,* U.S. , 24 L Ed 245 (1970) at p. 298:

"* * * Thus, it now appears the State has documentary evidence that the actual facts simply do not present the issue for which certiorari was granted by us.

* * * * *

"In this state of affairs we decline to adjudicate this case. Were we to pass upon the purely artificial and hypothetical issue tendered by the petition for certiorari we would not only in effect be rendering an advisory opinion but also lending ourselves to an unjustifiable intrusion upon the time of this Court. Accordingly, the writ of certiorari is dismissed as improvidently granted."

Accord:

Stern & Gressman, Sup. Ct. Prac. (4th Ed. 1969), §6.37, p. 297;

Tyrrell v. *District of Columbia,* 243 U.S. 1, 61 L Ed 557, 558, 559 (1916);

S. S. Monrosa v. *Carbon Black Export,* 359 U.S. 180, 184, 3 L Ed 2d 723, 726, reh. den. 359 U.S. 993, 3 L Ed 2nd 986 (1959);

Dick v. *New York Life Ins. Co.,* 359 U.S. 437, 444-445, 3 L Ed 2d 935, 941 (1959);

McCarthy v. *Brunner,* 323 U.S. 673, 89 L Ed 547 (1944).

This well established rule applies to the first four questions presented by petitioners. We shall discuss each of the questions raised by petitioners in the order presented in the petition.

The First Question

Petitioners contend (Pet. p. 18) that in awarding judgment to Defiance, rather than to its innocent shareholders, the courts below were in a "strait jacket"; that "Federal remedies do not depend on State law even in diversity cases" (Pet. p. 19); and that in this case, "State law was erroneously applied"

(Pet. p. 20). Petitioners also suggest (Pet. pp. 21-22) that there is a conflict among the Courts of Appeal over whether the *Erie* doctrine is applicable and obligates federal courts in a diversity case to apply state court remedies. These contentions were not advanced in the courts below and are made for the first time on this application. This circumstance, alone, warrants denial of petitioners' application for a writ of certiorari. (*Moor* v. *Texas & New Orleans R. Co.*, 297 U.S. 101, 105, 80 L Ed 509, 511 (1935); *NLRB* v. *Pittsburgh S.S. Co.*, 340 U.S. 498, 503, 95 L Ed 479, 483 (1951)).

It is clear, moreover, from the opinions below that neither the District Court, nor the Court of Appeals, in awarding judgment to Defiance, rather than to its shareholders, was constrained to do so by "state law". Indeed, neither court made any mention of the requirements of state law, or of the question of a conflict among the circuits with respect to the applicability of state law. Petitioners did not raise, nor did the courts below discuss, the applicability of the *Erie* doctrine.

In awarding judgment in favor of Defiance, the courts below followed generally accepted equitable principles applicable to derivative actions in both federal and state courts and were in no way "strait-jacketed" by requirements of state law.* Accordingly, petitioners' reference (Pet. p. 20) to the court's alleged erroneous application of *Erie* v. *Tompkins, supra* has no relation to the facts of this case.

The District Court denied petitioners' motion for a new trial upon the ground that (A 58 to A 59):

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* Petitioners agree (Pet. fn. p. 22) that "neither the law of Ohio nor the law of New York would prohibit recovery directly to independent shareholders although the suit is brought derivatively on behalf of the corporation". Accordingly, since state law permits the remedy petitioners now urge, the courts below were not "straitjacketed" by state law.

> "The *general rule* in a derivative action is that recovery is awarded to the corporation on behalf of which suit is brought, and that the corporation may not be 'by-passed' by an award to individual stockholders on a pro rata basis, which would, in effect, declare a dividend of the corporate recovery. See *Liken* v. *Shaffer*, 64 F. Supp. 432 (N.D. Iowa 1946, per Graven, J.); *Keenan* v. *Eshleman*, 23 Del. 234, 2 A. 2d 904, 912-13 (1938); 13 Fletcher Cyclopedia of Corporations (1961) 641-47 § 6028.
>
> "This case does not fall within the exceptions to this rule which have occasionally been made to avoid unnecessary litigation * * * " (Emphasis ours).

In affirming, the Court of Appeals likewise based its decision on generally accepted principles of equity and made no distinction between state and federal court remedies in derivative suits. The Court of Appeals held (A 4):

> "The corporation by issuing shares to its controlling officers and directors for less than their fair value was obviously damaged to the extent of the difference which was $2,992,940 because it received IIE shares worth only $40.58 per share in return for its shares which were worth $70.51 per share. Under such circumstances those fiduciaries who caused the corporation to part with its assets for less than their fair value must make up the difference *to the corporation.*" (Emphasis ours)

Thus, the courts below, in the exercise of their discretion, adopted the remedy they deemed most appropriate in the circumstances, with regard to state law. It is clear that petitioners seek review by this Court, *of a principle* not presented by the facts.*

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* Even in those cases cited by petitioners (Pet. pp. 21-22), where the issue of state law *versus* federal law is alleged to have been involved, this Court never deemed the question of sufficient importance to grant certiorari. *A fortiori,* it should not be granted here, where the question does not arise.

Nor can there be any doubt that the form of relief awarded was altogether appropriate. It would seem to be elementary that when a corporation issues shares to its controlling officers and directors for less than their fair value, the corporation is damaged to the extent of the difference. (*Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 203 (5th Cir. 1960), cert. den. 365 U.S. 814, 5 L.Ed. 2d 693 (1960); *Simon* v. *New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966).) Obviously, if defendants had paid fair value to Defiance, it would have in its treasury the amount which they pocketed. Therefore, it is a *non sequitur* for petitioners to compare (Pet. p. 5) Defiance's damage with its prior net worth.

Petitioners advance the novel contention (Pet. p. 15) that Defiance's issue of an excessive number of its shares to acquire IIE resulted only in giving "a disproportionate equity in Defiance" to the IIE shareholders; and that "Defiance, itself, lost nothing" because it "gave up nothing but pieces of paper" (Pet. p. 10).

As the District Court found, and the Court of Appeals affirmed, the "pieces of paper", which petitioners exacted from Defiance, had a value of $14.49 per share (A 25, 2-3). It necessarily follows that Defiance was damaged when petitioners grossly underpaid it for the "pieces of paper" which they received from it.

As stated in *Hooper* v. *Mountain States Securities Corp.*, *supra*, (282 F. 2d at p. 203):

> "Even in our remote position, we would be blind to all we hear and read about were we to succumb to the artificial contention that the issuance of this stock made the corporation no poorer so that the

> only persons who suffered were the stockholders for whom the suit cannot be brought by the Trustee."
>
> "* * * it would be unrealistic to say that a corporation having the capacity to acquire $700,000 worth of assets for its 700,000 shares of stock has suffered no loss if what it gave up was $700,000 but what it got was zero."

Petitioners argue (Pet. p. 16) that "it is inequitable to take the rigid view that in every case where shares are issued by the corporation there is damage to the corporation if the shares issued are excessive in number". The fact is that the courts below did not take a "rigid view" of the relief to be awarded, but granted judgment in favor of Defiance after a careful review of all the circumstances. We do not perceive how it is "unrealistic and unfair" (Pet. p. 17) to petitioners to require them to pay Defiance the full fair value of the shares they exacted from it.

Upon defendants' theory, the recovery in a derivative action would rarely, if ever, go to the corporation. But it is the award of damages directly to shareholders, which is the rare exception.

In *J. I. Case Co.* v. *Borak,* 377 U.S. 426, 432, 12 L Ed 2d 423, 427, this Court held:

> "The injury which a stockholder suffers from corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done *to the corporation,* rather than from the damage inflicted directly upon the stockholder." (Emphasis ours)

In *Ross* v. *Bernhard, et al.,* U.S. ; L Ed 2d (Feb. 2, 1970), this Court again affirmed the principle that in a derivative suit

> "Although named a defendant, it [the corporation] is the real party in interest, the stockholders being at least the nominal plaintiff. The proceeds of the action belong to the corporation and it is bound by the result of the suit."

The consensus of the authorities is that:

> "Generally, where the action is a derivative one brought for the benefit of a going corporation, equitable principles demand that the theory of the action be recognized and that the whole recoverable amount be decreed to be paid to the corporation." (13 Fletcher, Cyclopedia of Corporations (1961, Rev. volume) § 6028, p. 641)

Accord:

> 2 Hornstein, *Corporation Law and Practice* (1959) § 731, pp. 246-247;
> Henn *on Corporations* (1961) Sec. 375, p. 592.

The District Court held (A 59), and the Court of Appeals affirmed (A 3-4), the instant case does not fall within the rare exceptions to the general rule that in a derivative suit the recovery belongs to the corporation on whose behalf the suit is brought. Accordingly, the District Court found that the cases cited to it by petitioners (Pet. pp. 17-19) were inapplicable (A 60); and concluded that (A 60):

> "Accordingly, since none of the special circumstances in which pro rata recovery has been awarded exist here, the theory of the derivative action must be recognized and recovery awarded to the corporation."

All of the cases cited by petitioners (Pet. pp. 17-20, 22-23) are either cases where the corporation on whose behalf

the suit was brought was bankrupt and the shareholders, therefore, had no standing to sue (*Marin* v. *England*, 385 U.S. 99, 17 L.ed 2d 197 (1966); or where a closely held corporation was involved and the action was essentially one among partners (*Gallagher* v. *Perot*, 112 Misc. 717, 183 N.Y. Supp. 257 (Sup Ct. 1918) aff'd 200 A.D. 867, 191 N.Y. Supp. 926, aff'd 234 N.Y. 516 (1922); or where the corporation was extinguished upon a merger* (*Southern Pacific R.R.* v. *Bogart*, 250 U.S. 478 (1919); *de Haas* v. *Empire Petroleum Co.*, 300 F. Supp. 834 (D. Colo. 1969)); or where the action was one for recovery by the suing stockholders individually or was an alternative to valuation proceedings, when no damage to the corporation was charged (*May* v. *Midwest Refining Co.*, 121 F. 2d 431 (1st Cir. 1941) cert. den. 314 U.S. 668, 86 L.ed. 534 (1941); *de Haas* v. *Empire Petroleum Co.*, 300 F. Supp. 834 (D. Colo. 1969); *Perlman* v. *Feldman*, 219 F. 2d 173 (2nd Cir. 1955), or where the suing stockholders were disqualified because they took their shares from the wrongdoers, or had acquired their stock after the date of the commission of the wrongs complained of (*Home Fire Ins. Co.* v. *Barber*, 67 Neb. 644, 93 N W, 1024 (1903); *Mathews* v. *Heedley Chocolate Co.*, 130 Md. 523, 100 Atl, 645 (1917)).

Petitioners' contention really is that in a derivative suit, involving the issue of corporate stock to fiduciaries for an inadequate consideration, the award *must* be made to the innocent shareholders (Pet. pp. 17, 22). If sustained, such a holding would seriously undermine the therapeutic utility

* Petitioners' intimation (Pet. fn. p. 19) that the merger of Defiance into El Tronics Inc. has some bearing on this case is incorrect. Defiance was merged into El Tronics long after the judgment was rendered here.

of derivative suits, particularly as a means of enforcing the provisions of the Act.*

This Court recently stated in *Mills* v. *Electric Auto-Lite Co.*, U.S. , 24 L.ed. 2d 593, 609 (January 20, 1970), that "private stockholders' actions of this sort 'involve corporate therapeutics' and furnish a benefit to all shareholders by providing an important means of enforcement of the proxy statute". Again, in *J. I. Case Co.* v. *Borak, supra* (377 U.S., p. 432) this Court held that "Private enforcement of the proxy rules provides a necessary supplement to Commission action."

Petitioners' reliance upon the decision of this Court in *Mills* v. *Electric Auto-Lite Company, supra,* is misplaced. In that case, Electric Auto-Lite was acquired on terms which were inadequate and unfair to its shareholders. The corporate existence of Electric Auto-Lite was extinguished upon the merger. As this Court pointed out in *Mills,* "Petitioners asserted the right to complain of this alleged violation both derivatively and *as representatives of the class of all minority shareholders*". (Emphasis ours) Plaintiffs in *Mills* sought to either void the merger, or to recover the fair value of their shares. Even under those circumstances, this Court did not determine the *form* of the relief, but left the selection of the proper remedy to "the sound

* To "by-pass" the corporation would inevitably lead to a hornet's nest of future litigation. The Court would be called on to determine whether stockholders at the date the vote approving the exchange was adopted, or at the date when the exchange was consummated, should share in the award. Also, the Court would be required to determine the amount of each shareholder's damage and whether the right to participate in the award passed with a sale of the shares. Undoubtedly, it would be also necessary for the Court to appoint a Master to adjudicate the claims and to supervise distribution.

discretion which guides the determination of courts of equity".

The instant case represents the reverse of the situation in *Mills*. Here, Defiance *paid* excessive consideration to acquire the outstanding stock of IIE, which was largely owned by petitioners and Krock. Defiance continued in existence thereafter. Obviously, Defiance itself could have maintained an action for damages against its faithless fiduciaries, and would have done so, were it not under their control. Had Defiance, itself, brought the action, any recovery it obtained would, necessarily, have belonged to it.

Apparently the real complaint of petitioners is that in "molding" the equitable remedy in this case, the courts below did not exercise their discretion as petitioners would have liked. But it is well established that this Court will not review the manner in which the courts below have exercised their discretion. (*Moor* v. *Texas & New Orleans R. Co.*, 297 U.S. 101, 105, 89 L ed 509, 511 (1935); *Appalachian Power Co.* v. *American Institute of Certified Public Accountants*, 361 U.S. 30, 4 L ed 2d 30, 80 S. Ct. 16 (1959); *N.L.R.B.* v. *Pittsburgh S.S. Co.*, 340 U.S. 498, 502-503, 95 L ed 479, 482-483 (1950).)

In any event, petitioners' contention that equity should "mold its decree" (Pet. p. 17) is beside the point. In a derivative suit, the stockholder plaintiff ordinarily stands in the shoes of the corporation and can enforce against its fiduciaries only those claims which the corporation itself could have asserted. As this Court declared in *Ross* v. *Bernhard*, *supra*, in sustaining the right of a derivative plaintiff to a jury trial:

> "The heart of the action is the corporate claim. If it presents a legal issue, one entitling the corporation to a jury trial under the Seventh Amendment, the right to a jury is not forfeited merely because the stockholder's right to sue must first be adjudicated as an equitable issue triable to the court."

In the case at bar, the cause of action against petitioners is essentially an action at law to recover money damages. This, in fact, was the only relief awarded by the District Court. There should be no doubt that, in the instant case, plaintiff is entitled to enforce the legal claim of Defiance to recover money damages, precisely as Defiance could have done, had it been in a position to sue in its own name.*

The Second Question

Petitioners contend (Pet. p. 12) that "both the District Court and the Court of Appeals completely ignored a stipulation incorporated into the pre-trial order that the shares of Defiance had a market value of $11.625 per share on the date the proxy statement was issued". Petitioners suggest (Pet. p. 26) that this alleged violation of F.R.C.P. 16 "should be remedied by this Court in its supervisory capacity".

The fact is that the courts below did *not* ignore the pre-trial order. The pre-trial order merely stipulated the market quotations of Defiance's shares based on "the average between the bid and asked prices" on May 8, 1962 (R 139a).

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* The doctrine that a derivative suit, though equitable in form, is in fact legal, if the corporate claims which the suit seeks to enforce are legal in nature, is well established. (*Potter* v. *Walker*, 276 N.Y. 15 (1937); *Dunlop's Sons, Inc.* v. *Spurr*, 285 N.Y. 333 (1941)).

There was no actual sale of any shares of Defiance on that date (R 122a).

The District Court *accepted* the stipulated market price of Defiance's shares "as one of the factors in arriving at a value for Defiance stock", but held that "it is neither controlling nor conclusive" (A 50). As petitioners would have it, the effect of the stipulation in the pre-trial order was to *preclude* the District Court from entertaining any *other* evidence of the fair value of the stock of Defiance. We submit that the pre-trial order does not provide, and was never intended to accomplish, any such result.

The purpose of a pre-trial order is to limit the issues and to avoid proof as to facts which can readily be proved. The market price of Defiance's shares was a fact that could readily have been established and was, therefore, stipulated. The materiality and relevance of this fact was expressly reserved for the trial (R 132a). It is absurd for petitioners to attempt to stretch this stipulated fact relating to *market price* into a concession, binding on the Court, that $11.625 was the *fair value* of Defiance's shares and that no other evidence on this issue was admissible.

Indeed, it is clear from the stipulation itself that the issue of the fair value of the Defiance stock was reserved for the trial. Thus, the stipulation provided that among "the issues to be tried" was whether the shares issued by Defiance on the exchange constituted "excessive and exorbitant consideration for the 99,998 shares of the stock of IIE acquired in exchange". (R 148a) Moreover, the pre-trial order expressly noted that "plaintiff claims that such excess is approximately in the sum of $3,335,000" (R 147a), a figure which could not have been remotely achieved if the market price of $11.625 were to be deemed final and controlling.

Moreover, throughout the trial petitioners and respondent both accepted the finding of Hayden Stone & Co., petitioners' own expert, that the fair value of Defiance's shares at the time of the exchange was $14.49 per share. This valuation was not put in issue by petitioners.* It was not until after the District Court had rendered its opinion accepting the finding of Hayden Stone and holding petitioners liable that petitioners for the first time on their motion for a new trial contended that the District Court should have accepted the lower *market price* of the Defiance shares as conclusive evidence of value.

In denying that motion, the District Court held (A 49):

> "Throughout the trial defendants accepted as authoritative the Hayden Stone report, including its valuation of the stock to be issued by Defiance at $14.49 per share and although they were given ample opportunity to challenge it or to offer any evidence tending to show a lower value for the Defiance stock, they chose not to do so. The report therefore constitutes probative and convincing evidence, particularly since it represents the results of an independent appraisal by recognized experts in the evaluation of corporate properties, who were eminently well qualified. Repeatedly the defendants pointed to the fairness of the report, Muscat going so far as to testify that the effect of the report was to render the Defiance transaction an arm's-length one."

The District Court could have arrived at a value other than $14.49 for the shares of Defiance only by disregarding petitioners' (and respondents') consistent position through-

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* Upon the trial petitioners contended only that Hayden Stone's evaluation of IIE at $70.51 per share was also correct. This was disputed by respondent and was the central issue at the trial.

out the trial, a position which petitioners abandoned only after the trial was concluded and judgment had been rendered against them. To belatedly give the pre-trial order the effect now contended for by petitioners would be to change *ex post facto* "the whole course of the trial, the whole tenor of it". *(Laird v. Carrier Engine Service Co.,* 263 F. 2d 948, 952 (5th Cir. 1959).)

The language of Mr. Justice Brennan, in an opinion in Chambers, in the case of *Appalachian Power Co.* v. *American Institute of Certified Public Accountants,* 361 U.S. 30, 4 L Ed 2d 30, 32 (1959), aptly applies to the case at bar:

> "But ordinarily an application by a District Court of the Rules of Civil Procedure when affirmed by the Court of Appeals will not be reviewed by this Court. This is particularly true where, as here, the question is one that concerns the judgment of the District Judge in relation to a particular set of facts."

We submit that the question here raised by the petitioners has no application to the facts of the case, and the decision of the District Court "made in relation to the particular set of facts" before it should not be reviewed by this Court.

Petitioners further contend (Pet. p. 25) that the allegation of the complaint that the Defiance's stock had a fair and reasonable value of $11.50 per share "should be binding on the plaintiff".* FRCP, Rule 8(f) expressly declares that "all pleadings shall be so construed as to do substantia justice". Rule 15(b) further provides that the allegations of a complaint do not preclude a court from rendering judgment in accordance with the facts as found by it after trial. This should be especially so in a derivative suit where

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* See: *Giannone* v. *United States Steel Corporation,* 238 F.2d 544, 547-548 (3rd Cir., 1956).

the rights of many absentee stockholders are involved. The District Court was fully justified in fixing the value of the Defiance stock at $14.49 per share, particularly since both sides accepted that valuation throughout the trial.

The Third and Fourth Questions

Petitioners contend (Pet. p. 27) that "no Court of Appeals has ruled on the requirement for *scienter* in an action for damages where §§ 10 and 14 overlap * * * " and petitioners urge (Pet. p. 29) that this Court should grant re- were not disclosed in the proxy statement, on the basis of which the Defiance-IIE exchange of stock was approved.

The issue raised by petitioners is irrelevant in the case at bar. The District Court found as a *fact* that petitioners had *personal knowledge* of at least two material facts which were not disclosed in the proxy, on the basis of which the Defiance-IIE exchange of stock was approved.

The principal issue on the trial was the fraud of petitioners in inflating the earnings of IIE's principal subsidiary, Nablico, and thereby inflating the value ascribed to IIE. The proxy statement represented the earnings of Nablico to be $2,098,013 for the period 1958-1961, inclusive. However, an audited report by the eminent accounting firm of Peat, Marwick, Mitchell & Co. certified Nablico's earnings for the same years to be only $1,501,882.* The District Court found *as a fact* (A 34) "that Huffines and Muscat, two knowledgeable and experienced business executives in charge of Nablico's affairs were aware of its true earnings".

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* In evaluating IIE, Hayden Stone had multiplied the inflated earnings of Nablico by 14 and 15 times and used the average of such multiplied earnings, plus a 25% premium for control, as the basis for its evaluation of Nablico. The impact of this method of evaluation upon the value of Nablico and, therefore, upon the value of IIE, needs no elaboration.

Again, it is undisputed that prior to the circulation of the proxy statement, two of Nablico's policy holders had instituted suit against it, claiming they were entitled to dividends equal to those paid to shareholders. Long before the proxy statement was mailed to Defiance's shareholders, those plaintiffs recovered judgment against Nablico in the sum of $5,500 on a motion for summary judgment (A 28).

Petitioners knew of this judgment before the proxy statement was issued (A 35). Moreover, they were fully aware that this judgment, in favor of two, out of many, policy holders, was a portent of more claims to come. As the District Court found (A 35), petitioners "knew of the adverse judgment and of the probability of substantial additional claims, facts which should have been disclosed in the proxy statement".* We submit that since the courts below found *on the facts* that petitioners had personal knowledge of the falsity of the proxy statement, the issue of *scienter* as a condition precedent to recovery under §§ 10 and 14 of the Act and Rules 10b-5 and 14a-9 is not an issue in this case.

Similarly, petitioners' contention (Pet. p. 30) that the "clearance" of the proxy statement by the staff of the SEC "negates fraud and shows due diligence", does not relate to the circumstances of this case. Petitioners seek to create the impression that the finding of fraud against them was based merely on an "alleged misclassification of the figures" (Pet. p. 31) and an improper arrangement "of the disclosed figures" (Pet. p. 32).

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* Up to March 1965 the amount paid in settlement of these claims was $162,000 (A 28) and, as the District Court held, the amount of "additional claims remains undetermined". (A 28)

However, the finding below that the proxy statement was false and misleading was not based, as petitioners would have it, merely on the *arrangement* in the proxy statement of *disclosed facts*. As noted above, *supra*, pp. 23-24, the finding of fraud in the proxy statement was based, in large part, on *undisclosed facts*. As the District Court held, these facts were known to the petitioners, but withheld from the SEC (A 37).*

Petitioners agree (Pet. p. 31) that "There may be cases of material omissions or misstatements, where scant comfort can be found in the clearance by the SEC". This case is surely one of them. In the instant case, the District Court expressly found (A 37) that "There is no indication that the SEC was aware, as were the defendants, of the inflation in the Nablico earnings figures used in the proxy solicitation material * * *." This is, therefor, a clear case of *knowingly* withholding material information from the SEC.

Again, it is clear from the record that the petitioners failed to disclose to the SEC the judgment which had been rendered against Nablico in favor of two of many similarly situated policy holders (A 28). It is obvious that that information, too, was withheld from the SEC, since it is inconceivable that, had it been disclosed, the SEC would

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* It may be noted that in *Mills* v. *Electric Auto-Lite Co.*, 403 F. 2d 429, 433 (2 Cir. 1968), judgment vacated, *supra*, U.S. , 24 L Ed 2d 593 the Court's finding that the proxy statement was misleading was based on the failure to give "the same emphasis" to the recommendation of the board of directors supporting the merger, as to the relationship of Electric Auto-Lite's directors with the principal corporate defendant. The Court in *Mills* noted that the disclosure of their "close relationship" came "many pages later". Thus, the falsity of the proxy statement in *Mills* was a matter only of the *arrangement* of the facts.

not have insisted upon the inclusion of this important fact in the proxy material. Accordingly, the District Court concluded that the SEC had been "misled" (A 37) by petitioners. Petitioners would hardly contend that the "clearance" of a proxy statement, where vital information has been *withheld* from the SEC, negates fraud.

The issues raised in questions 3 and 4, therefore, of the necessity of *scienter* as a condition to liability for a false proxy and as to whether a fully informed SEC "clearance" should insulate from such liability, is not present in this case. It would be a futile exercise for this Court to grant certiorari to discuss a *principle* applicable to a case, unlike the case at bar, in which all of the material facts *were* fairly disclosed.

The Fifth Question

What the petitioners really seek is a new hearing in this Court on the factual issues in this case. This Court, in "repeated pronouncements", has held that it 'cannot undertake to review concurrent findings of fact by two courts below, in the absence of a very obvious and exceptional showing of error'. E.g., *Graver Mfg. Co.* v. *Linde,* 336 U.S. 271, 275, 93 L Ed 672, 676, 677, 69 S. Ct. 535". (*Berenyi* v. *Immigration Service, supra,* (385 U.S. at p. 635); *Graver Mfg. Co.* v. *Linde,* 336 U.S. 271, 275, 93 L Ed 672, 676, 677, 69 S. Ct. 535 (1948); *Comstock* v. *Group of Institutional Investors,* 335 U.S. 211, 213-214, 230, 92 L Ed 1911, 1915, 1924 (1947).)

Petitioners contend (Pet. p. 32) that "without arguing the fairness of the exchange", if this Court "grants the instant petition on any of the previous points, to do substantial justice, it should review the finding that the ex-

change was grossly unfair". We submit that since the "previous points" raised by petitioners do not warrant review by this Court, the factual question of the fairness of the Defiance-IIE exchange certainly does not.

The fairness of the exchange ratio was the principal issue of fact litigated upon the trial. Upon the trial, both sides accepted the Hayden Stone evaluation of Defiance at $14.49 per share as proper. Petitioners' sole contention was that Hayden Stone's evaluation of IIE at $70.51 per share was also correct and that, therefore, the exchange ratio adopted was reasonable.

The District Court found, however, that with respect to IIE, Hayden Stone had been "misled" (A 45) because the purported earnings of Nablico (IIE's principal asset), supplied to Hayden Stone, had been substantially inflated (A 25). Accordingly, the District Court rejected Hayden Stone's evaluation of IIE and held that petitioners had caused Defiance "to pay $70.51 per share for IIE shares worth $40.58, or an excess of $29.93 per share" (A 34).

In these circumstances, the District Court necessarily concluded that the exchange involved "gross unfairness" (A 18) to Defiance. It is difficult to understand on what basis petitioners believe that this Court should review this issue of fact as decided by the District Court and affirmed by the Court of Appeals.*

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* We are at a loss to understand petitioners' statement (Pet. p. 32) that the SEC found that the income figures for Nablico stated in the proxy statement "were not false and misleading". As noted above, *supra* p. 26, the District Court found that the SEC was *unaware* of the gross inflation of Nablico's income figures.

CONCLUSION

The petition for a writ of certiorari should be denied since petitioners make no showing of any basis for such relief (Supreme Court Rule 19).

Respectfully submitted,

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APPENDIX

Federal Rules of Civil Procedure

Rule 8. General Rules of Pleading.

* * *

(f) *Construction of Pleadings.* All pleadings shall be so construed as to do substantial justice.

Rule 15. Amended and Supplemental Pleadings.

* * *

(b) Amendments to Conform to the Evidence. When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings. Such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issues may be made upon motion of any party at any time, even after judgment; but failure so to amend does not affect the result of the trial of these issues. If evidence is objected to at the trial on the ground that it is not within the issues made by the pleadings, the court may allow the pleadings to be amended and shall do so freely when the presentation of the merits of the action will be subserved thereby and the objecting party fails to satisfy the court that the admission of such evidence would prejudice him in maintaining his action or defense upon the merits. The court may grant a continuance to enable the objecting party to meet such evidence.

* * *

SUPREME COURT RULES

Rule 19. Considerations governing review on certiorari.

1. A review on writ of certiorari is not a matter of right, but of sound judicial discretion, and will be granted only where there are special and important reasons therefor. The following, while neither controlling nor fully measuring the court's discretion, indicate the character of reasons which will be considered:

(a) Where a state court has decided a federal question of substance not theretofore determined by this court, or has decided it in a way probably not in accord with applicable decisions of this court.

(b) Where a court of appeals has rendered a decision in conflict with the decision of another court of appeals on the same matter; or has decided an important state or territorial question in a way in conflict with applicable state or territorial law; or has decided an important question of federal law which has not been, but should be, settled by this court; or has decided a federal question in a way in conflict with applicable decisions of this court; or has so far departed from the accepted and usual course of judicial proceedings, or so far sanctioned such a departure by a lower court, as to call for an exercise of this court's power of supervision.

2. The same general considerations outlined above will control in respect of petitions for writs of certiorari to review judgments of the Court of Claims, of the Court of Customs and Patent Appeals, or of any other court whose determinations are by law reviewable on writ of certiorari.

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Supreme Court of the United States

OCTOBER TERM, 1969

No. 1135

VICTOR MUSCAT and R. L. HUFFINES, JR.,

Petitioners,

against

NORTE & CO.,

Respondent.

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Replying to Point I—First Question (Resp. Br., pp. 10-19)

The suggestion that the questions posed in the petition for certiorari are "hypothetical" is frivolous. To say that the difference between a judgment for $625,038 (which we contend is the limit of liability) and a judgment of $3,777,346 is "hypothetical" is to miss the issue completely.

Respondent fails to discuss the basic questions. We claim that where there is a *practical merger,* the only harm that results from an over-valuation of securities on one side of the exchange is to the minority stockholders who suffer dilution of their proportionate equity and not to the corporate entity itself. Despite its citation of a case

like *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 203 (5th Cir. 1960), cert. den. 365 U. S. 814 (1960), cited in our petition, page 16, respondent nowhere discusses whether there is a difference between the sale of worthless property to a corporation for shares, as in *Hooper,* and the case at bar where there has been an exchange of shares, resulting in an acquisition of 100% of the acquired corporation. Significantly, no case is cited by the respondent in which 100% of the stock of one of the companies in the exchange has been acquired. In such case, the true loss is that of the non-controlling stockholders who have suffered a dilution of their equity, and is not that of the acquiring corporate entity itself. Whether the acquired corporation (IIE) had been actually liquidated into the parent immediately after its acquisition or not there still is merely an unfair rearrangement of the *equities of the stockholders.* That is what should be redressed. The argument that our position would imply that recovery in "the derivative action would rarely, if ever, go to the corporation" (Resp. Br., p. 14) is simply not correct. On the contrary, in cases where there was actual damage to the corporate entity as in the ordinary cases of waste, the derivative action lies on behalf of the corporation. We ask that equity be held not to permit an award of "damages" to stand which is a windfall.

We must emphasize that neither in its brief below nor in its present brief does the respondent challenge the cardinal point that the minority stockholders of Defiance (other than the defendant controlling stockholders of Defiance) lost only $625,038 (Pet., p. 5) instead of $3,777,346, the amount of the judgment (A70-71). The controlling stockholders, the alleged wrongdoers, moreover, would regain their aliquot portion of the judgment on behalf of the corporation only if they had retained their shares and were sufficiently wealthy and liquid to pay the full amount of the enormous judgment and recoup it indirectly through their continuing stock ownership in the corpora-

tion. The respondent also fails to answer the point that the recovery to the corporation results in a double windfall to the minority stockholders of IIE, the acquired corporation. They have already had one windfall, according to the Court's finding. Now they will obtain another if they have held on to their stock in Defiance. The recognition that the defendant controlling stockholders would share in the recovery if they held their stock shows the fortuitous nature of the remedy provided by the Courts below. We believe that the only proper relief in this situation is to require a payment of the actual loss to the minority stockholders who relied upon the alleged false proxy statement. The judgment below is certainly grossly in excess of the true measure of the actual loss suffered.

Moreover, it is far from "obvious", as respondent mistakenly contends, that "if defendants had paid fair value to Defiance, it would have in its treasury the amount which *they* pocketed" (Resp. Br. p. 13; emphasis ours). The fact is, and it was uncontested below, that petitioner's paper profit on the Court's own figures was only $740,295, since if the acquisition of IIE stock by Defiance was a "lemon", the petitioners by receiving Defiance shares in the exchange acquired their share of the "lemon".*

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* Prior to the acquisition there were 221,225 shares of Defiance outstanding (Ex. 1, p. 9). At the Court's figure of $14.49, this gave a net worth to Defiance of $3,205,550. Muscat, Huffines and Krock owned 44,300 shares of Defiance (420,157 less 375,857—51a). This was an equity for them of $641,907. The total value of IIE again at the Court's figure of $40.58 per share for the outstanding 99,998 shares was $4,056,296. The Muscat group owned 77.1% (Ex. 1, p. 9) of IIE giving them an equity of $3,127,404. Their combined equity in the two companies before Defiance acquired IIE was therefore, $3,769,311.

After the acquisition the group owned 62.1% of Defiance (30a) Since the combined value of the two companies, under the Court's opinion was $3,205,550 plus $4,056,296 or $7,261,846, the equity of the group was now, therefore, 62.1% of the combined figure, or

(*Footnote continued on following page*)

The respondent is also in error when it says that there is no issue respecting the fashioning of equitable remedies by the Federal Courts on state causes of action (Resp. Br., p. 9). The action in suit seeks an accounting for alleged breaches of fiduciary duty, among other things. Indeed, the Court in *Ross* v. *Bernhard,* No. 42 (decided February 2, 1970) specifically excludes from its holding that the plaintiff in a derivative suit for damages has a constitutional right to a jury trial cases where, as in the instant case, breach of fiduciary duty is alleged. Respondent concedes that "equitable principle" is involved (Resp. Br., p. 7). We contend that so far as the Federal cause of action is concerned—arising from the alleged violation of the proxy rules—the Federal Court, as we have pointed out, should do equity by not increasing the judgment to a sum *more than four times* as much as the minority stockholders actually lost. We contend, moreover, that with respect to the state causes of action based upon diversity of citizenship, the Federal Courts similarly have a duty to mold equitable remedies to do justice and that they are not bound by the remedies of State law. *Guaranty Trust Co.* v. *York,* 326 U. S. 99, 105 (Pet. pp. 17-23). In short, the Federal Courts should be instructed by this Court that in granting relief they must "prevent unjust enrichment". *Southern Pacific Co.* v. *Bogert,* 250 U. S. 478, 497 (1919). The Federal Court with jurisdiction over a State law cause of action should mold its decree to do fundamental justice with respect to the state causes of action as well. We submit that the Federal Courts should not feel bound to apply state law remedies.

The importance of the issue here involved is that in the growing area of litigation by minority interests in Fed-

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(*footnote continued from preceding page*)

$4,509,606. The paper profit was the difference between their former equity of $3,769,311 and their present equity of $4,509,606, or $740,295.

The District Court was clearly erroneous when it found petitioners to have profited by $2,703,910.

eral Court, justice and fair play require the judicial recognition of guide lines to prevent excessive and unjust recoveries.* While the pendulum has swung far in behalf of minority rights, as is proper, the warning of Mr. Justice Brandeis should be borne constantly in mind—Courts of equity should "prevent unjust enrichment."

Replying to Point I—Second Question (Resp. Br., pp. 19-23)

Respondent's argument that the Courts below did not ignore the pre-trial order is untenable. The pre-trial order was more than a recital of a market price per share. It stipulated that "Defiance issued 487,502 shares of its Class B stock, having a market value of $5,677,211." It stipulated that the facts in the pre-trial order were not in dispute (132a). The respondent itself, in its amended complaint, alleged that at the time Defiance was caused to acquire the outstanding stock of IIE as aforesaid, the shares of stock of Defiance had a "fair and reasonable value" of $11.50 per share (13a). The total "fair and reasonable value" was $5,606,263 (487,502 shares x $11.50). This is almost the same as the stipulated market value of $5,677,211 in the pre-trial order. The amended complaint was repleaded subsequent to the pre-trial order and after

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* Respondent's argument (Br. p. 17 fn.) that "to 'by-pass' the corporation would inevitably lead to a hornet's nest of litigation" is unfounded since the further question of which shareholders should get the recovery are questions of law to be decided by the Court—with the aid of computerized stock transfer sheets. Indeed, even if these questions should impose mechanical problems, they are no different from the problems posed by any other class actions which are liberally encouraged by Rule 23 of the Federal Rules of Civil Procedure and which are particularly important in enforcing the Securities Laws. Thus, the contention that enforcement of the Securities Laws would be seriously undermined (Resp. Br. p. 16) by permitting recovery to Defiance's independent shareholders is also without foundation.

the trial had begun. In the face of this, it is disingenuous to argue that the pre-trial order did not establish the agreement of the parties with respect to the fair and reasonable value of the Defiance shares.

No evidence was offered by the defendants with respect to the value of the Defiance shares. It could hardly be expected that they would offer any such evidence in the face of the purportedly binding pre-trial order. If the question of market value had been open the defendants could have proved that at the time of the actual exchange of stock the Defiance shares had fallen to about $8 a share, considerably less even than in the pre-trial order (137a). We also point out with the greatest respect for the trial Judge below that it was on his own motion after trial (which is not denied by the respondent) that Judge Mansfield sought material as to the volume of trading. He had not referred, in any way, to the market value in the pre-trial order in his first opinion. He then used the new material to cast doubt on the validity of the pre-trial order previously entered. It is against this that we complain. Indeed, calling for additional evidence was clearly contrary to the general tenor of the rule in the Tenth and other Circuits that "[t]he trial court may not disregard the facts stipulated to *or require evidence to support them.*" *U. S. v. Sommers,* 351 F. 2d 354 (10th Cir. 1965; emphasis ours; Pet. p. 24). We urge that it is a matter of the utmost importance in the conduct of Federal litigation for litigants to know that pre-trial orders, unless timely relief from their terms is obtained, are binding. Otherwise they are not merely useless but may be a trap for the unsuspecting. The distinguished Second Circuit itself recognized this in *Mull v. Ford Motor Co.,* 368 F. 2d 713 (1960), but disregarded the matter in considering the appeal herein, for what reason does not appear.

We urge that this Court, as supervisor of the procedure in Federal Courts, should not condone practice which ob-

viously will encourage lawyers to try every issue of fact—even those which are the subject of a stipulation in a pretrial order—defeating the very purpose for which Rule 16 was promulgated.

Replying to Point I—Third and Fourth Questions (Resp. Br., pp. 23-26)

The main reason for the conclusion that the petitioners are liable arises from the claim that there was an inflation in the Nablico earnings figures. It is quite clear from the record that the issue involved certain post-year adjustments of the earnings of the insurance company as they had been reported to the State Commissioner of Insurance of Texas. There is no doubt that the proxy statement used the same figures that were given to the Insurance Department of Texas. The basic difference was that post-year adjustments, as is customary in State insurance accounting, were entered directly to the surplus account rather than through the income account. No figure was concealed from either the SEC or the stockholder. The SEC staff and its accounting experts saw all the entries involving these post-year adjustments and also saw that they were in the surplus account rather than in the income account. Respondent does not claim the contrary. The SEC even suggested some changes in the surplus account, indicating that the treatment of the rest of the account was unexceptionable. We contend that in such circumstances of open disclosure there was no direct proof of fraud or scienter and that the standard imposed upon the laymen defendants with respect to accounting matters was too rigid in view of the SEC's own acceptance of the figures.

We rsepectfully suggest that the other alleged omissions or misstatements might not have been deemed material were it not for the Court's erroneous view of the accounting problem.

Replying to Point I—Fifth Question (Resp. Br., pp. 26-27)

We know of no rule which would prevent this Court from granting certiorari on matters involving the fairness of an exchange. See, for example, *U. S.* v. *ICC, Brundage* v. *U. S.* and *Livingston Anti-Merger Committee* v. *ICC* (Nos. 25, 38, 43 and 44). In any event, we have suggested that the Court should grant certiorari on the earlier points briefed and that if certiorari is granted, the Court should not limit its grant, but should also consider the fairness of the exchange.

CONCLUSION

For the foregoing reasons petitioners pray that a petition for a writ of certiorari in this case be granted.

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